**State of Vermont**
**Debt Management Policy**

**January 2012**

The purpose of this document is to provide guidance on current practices as they relate to the issuance, management, continuing evaluation, and reporting on all debt obligations issued by the State of Vermont, in relationship to the overall mission and internal control standards of the State Treasurer's Office.

## Mission Statement

Treasurer's Office will issue debt, in compliance with state statute and in compliance with applicable federal code, at the lowest possible interest rates, in the most cost-effective manner possible while maintaining the State's high credit ratings. Such issuance must balance both immediate costs and potential future savings, while minimizing potential regulatory, economic and market risks.

## Relationship to Treasury Mission and Vision

Debt service is a long-term, fixed obligation. Obtaining the most favorable rates on, tax supported debt programs through timely issuance, maintenance of high credit ratings, well thought out debt structures and taking advantage, where appropriate of refunding opportunities, directly benefits the State of Vermont and the taxpayers by saving tax dollars

## Primary Functions

This function, completed by Administrative and Treasury Operations staff, serves the, state agencies and departments, bond holders, and the citizens of the state. The Treasurer's Office provides central coordination for all state-issued debt. Staff also monitors local and national bond markets, as well as financial and economic trends that impact bond issuance structures and interest rates.

Primary functions include

- Debt financing review and program administration
- Debt program administration, including compliance and continuing disclosure, investor relations, and rating agency relationships
- Issuance of bonds or other securities
- Monitoring and execution of refunding opportunities
- Debt affordability analysis and recommendations to executive and legislative branches
- Debt financing and advisory services to state agencies, authorities, boards, commissions and higher education institutions
- Technical assistance on the financial aspects of legislative proposals, impact on debt capacity, financial studies and initiatives

- Managing the long-term accounting records needed for verifying and coordinating the payment of principal and interest with the fiscal agent and initiating supporting transfers required by the bond covenants
- Managing and monitoring arbitrage compliance and computing federal rebate calculations as needed
- Monitor post-issuance compliance

In completing the above functions there is considerable interaction with Finance & Management and Buildings & General Service, the departments primarily responsible for preparing the capital budget. Treasury staff also works with the Financial Operations Division of the Department of Finance & Management to record debt transactions and prepare disclosures for financial presentation in the state's Comprehensive Annual Financial Report (CAFR) and the bond disclosure documents (Official Statement).

## Debt Management Practices and Overview

### Current Practice

Historically, the State Treasurer's Office, in conjunction with the Administration and the Legislature, has set a course of maintaining modest levels of new authorizations of long-term debt and net tax-supported debt outstanding in a concerted effort to reduce debt burdens and to free up debt capacity for future projects. The approach is as follows:

- Bond issuance is substantially lower than in the 1990s. Reduced debt issuance and continued improvement in the State's economy and financial condition have lowered State debt ratios.

- Debt guidelines were strengthened in 2004. State now benchmarks against triple-A rated states.

- Uncomplicated debt management nearly exclusively using general obligation debt.

- Vermont has taken advantage of refunding opportunities, lowering debt service costs.

- The State has a low debt burden with rapid amortization.

The State's primary financing vehicle has been and continues to be the issuance of General Obligation (G.O.) bonds, backed by the full faith and credit of the State of Vermont, which includes a pledge of the general taxing power for the payment of debt obligation. Interest rates on G.O. bonds are generally lower than any other form of debt financing. The State generally issues serial G.O. bonds maturing one to twenty years from issuance date, with interest due every six months and principal due on the anniversary date of the bond. The principal portions of the bonds are paid in equal installments over the term of the bond series, while the interest payments for each series decline as the outstanding principal balance is reduced.

To date, the state has not utilized other mechanisms such as revenue bonds, GARVEES, tax increment financing or TIFs (these are done at the municipal level). The State's G.O. bonds are "plain vanilla"; the state does not employ the use of derivative strategies such as swaps, variable rate debt obligations (VRDO) or auction rate securities (ARS). The state does take advantage of refunding opportunities when available. A bond refunding is a procedure whereby an issuer refinances an outstanding bond issue by issuing new bonds. There are generally two major reasons for refunding: to reduce the issuer's interest costs or to remove a burdensome or restrictive covenant (generally not applicable in Vermont) imposed by the terms of the bonds being refinanced. Vermont's refunding has been related to reduction of interest costs. The proceeds of the new bonds are either deposited in escrow to pay the debt service on the outstanding obligations, when due (in which case the financing is known as an "advance refunding"), or used to immediately retire the outstanding obligations.

The State Treasurer's Office issued $44.5 million aggregate principal amount of general obligation bonds in fiscal year 2007. This included a $30 million Series A competitive offering in February 2007 with a true interest cost of 4.09 percent and average life of 12.4 years, followed by a $14.5 million negotiated "Citizens Bond" offering Series B and C in March 2007 with a true interest cost of 3.65 percent and average life of 4.8 years. The State's bond ratings discussed above contributed to the favorable interest rates achieved in both offerings.

For the current fiscal year (2008), the State issued three series of general obligation bonds. In November 2007, the State offered its $35,000,000 General Obligation Bonds, 2007 Series D. The Bonds were purchased by Merrill Lynch through a competitive bid process on Parity and were re-offered to retail and institutional investors. The bonds have an average life of 11.7 years and true interest cost of 4.30%. In December 2007, $11 million of 2007 Series E G.O. Citizens Bonds and (specifically offered to Vermont residents in denominations as low as $1,000) were offered with an average life of 5.1 years and true interest cost of 3.49%. The $46 million total of these three series fund capital projects throughout the State. Also in December 2007, the State issued $29.195 million of general obligation refunding bonds with an average life of 3.1 years and true interest cost of 3.33%. This issuance creates gross savings to the State of over $1.6 million through fiscal 2017 and present value savings of almost $1.1 million.

A major contributing factor to Vermont's respected debt management is the work of the Capital Debt Affordability Advisory Committee (CDAAC). The CDAAC completes an annual review of the size and affordability of the State tax-supported general obligation debt, and submits to the Governor and to the General Assembly an estimate of the maximum amount of new long-term general obligation debt that prudently may be authorized for the next fiscal year. The estimate of the committee is advisory, but historically has been adopted by the State as a bonding limit. This legislative adherence to CDAAC recommendations is a major factor in the investment community's recognition of Vermont as a highly disciplined state in financial affairs. The CDAAC is made up of four *ex officio* members and one appointee of the Governor. The State Treasurer serves as chair of the committee.

In September 2004, the committee adopted new guidelines consistent with Vermont's stated objective of achieving and maintaining a triple-A rating from all bond agencies. Vermont received a triple-A rating from Moody's Investor Services in February 2007 and maintains the next highest levels with Fitch and Standard & Poor's. A triple-A rating is attractive for a state because it offers a lower cost of capital to the state and favorably impacts the ratings and costs of borrowing for state agencies such as the Vermont Municipal Bond Bank, Vermont Housing Finance Authority, and Vermont Student Assistance Corporation.

## Uses of Long-term Debt Financing

According to State Statute, the Governor will submit, in addition to the general operating budget, a consolidated capital budget request for the following fiscal year, encompassing all projects that may require state general obligation debt financing, including transportation projects. Vermont uses a conservative approach to debt management. Long-term debt financing is not considered appropriate for a recurring purpose such as current operating and maintenance expenditures. The State of Vermont will use long-term debt financing only for capital improvement projects and equipment acquisitions included under the following circumstances (see 32 V.S.A. § 309, Capital Budget Report):

- General obligation debt financing is restricted to tangible capital investments, but may include the planning, design, and engineering directly associated with a tangible capital investment.

- Activities proposed through the capital plan are restricted to those capital expenses allowed under federal laws governing the use of state bond proceeds. For instance there is a "private activity" cap associated with each bond issuance.

- Capital needs should have identified life cycles that are matched to the debt issuance. The capital budget is segmented by the expected functional life of proposed activities, and thus by a corresponding prudent use of either long-term bond issues with a customary 20-year payback period, or shorter-term bond issues with a lesser payback period can be applied.

The primary methods for paying for capital projects are out of "pay-as-you-go" dollars or through the issuance of debt. Pay-as-you-go is a term used to describe the financial policy of a governmental unit that finances all of its capital outlays from current revenues rather than by borrowing. The State does fund some of its capital needs, particularly through pay-as-you-go. A balance between pay-as-you-go and prudent debt is needed. The advantages of pay-as-you-go are:

- No debt is incurred by the State improving the state's balance sheet.
- Costs of construction are not burdened by interest costs.

On the other, hand many capital projects may be delayed due to lack of resources. Recent studies completed by the Joint Fiscal office (JFO) and the Agency of Transportation (AOT) have demonstrated increased costs for repair of transportation (bridge) infrastructure when preventative work is deferred. In addition to this, if inflationary costs are higher than the interest associated with the debt, and significant economic advantages can be achieved, issuance of more debt can be a prudent decision. As noted by a recent study "Borrowing is cost-effective when the costs saved through accelerated construction, plus future project revenues, exceed the cost of interest paid on the borrowed funds." (Springer, p.4). There is also an argument to be made that borrowing provides for intergeneration equity in the sharing of the costs of new infrastructure and is a "good way to finance large public capital investments with high up-front costs that provide benefits to users for years, even generations." (Wachs, p.9) But borrowing must also be constrained by the ability to repay the debt. This is similar to an individual's decision about personal credit card use. Future streams of revenue are needed to pay the debt.

One of the challenges over the next few years is how to manage the debt portfolio in order to achieve a proper balance between the goal of low debt ratios and the accumulating capital needs of the State. While the State must continue a disciplined approach to debt financing of public infrastructure, several self-assessment steps are currently taking place to of whether Vermont's approach and policies of the past 20 years relating to debt management and infrastructure financing still make sense in light of current circumstances and remain appropriate for the future. Funding of infrastructure, especially transportation related, will become a more significant issue as traditional sources, such as motor fuel taxes, continue to be impacted by changing patterns emphasizing a reduction of reliance on oil.

## Debt Characteristics

### Types of Debt

Debt financing may include general obligation bonds, revenue bonds, lease/purchase as well as public improvement district bonds, and special assessment bonds. As noted above, the overwhelming method used by Vermont has been G.O. debt although some forms of revenue debt have been explored. The debt Procedures Manual provides a detailed description of the types of debt.

### General Obligation Debt Structure

The following guidelines, which may be modified by the State of Vermont to meet the particulars of the financial markets at the time of the issuance of a debt obligation, describe the basic structure.

> Term of the Debt: The financing will not exceed 20 years by statute. Bonds cannot be issued for a longer maturity schedule than a conservative estimate of the useful life of the asset to be financed.
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> Structure of Debt: Level debt service will be used unless otherwise dictated by the useful life of the asset(s).
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> Call Provisions: From an investor perspective, bonds are generally more marketable without call provisions. As a rule, investors normally prefer the certainty of a fixed maturity with no possibility of a call. On the other hand, this may inhibit the ability to take advantage of current refunding opportunities, thus reducing the debt service interest payments. To reward investors for the increased risk, callable bonds typically will carry a

higher interest rate. Generally the State strikes a balance, with bonds maturing after ten years subject to call at a redemption price of 100% of the principal amount of the bonds to be redeemed, plus accrued interest to the redemption date. This redemption price may rise to a premium under certain market conditions such as a high interest rate environment.

Premium or Discount: State practice requires that proceeds are at least equal to the principal amount of the capital budget. Pursuant to 32 V.S.A. §954 (a), bond premium received from the issuance of debt is to be used as part of the next interest or principal payment to bondholders.

Cost of Issuance: In addition to the interest on the amount borrowed, there are additional bond related expenses including, but not limited to:

- Bond Counsel Services
- Printing of Bond Documentation
- Credit Ratings Fees
- Trustee/Paying Agent Services
- Financial Advisor Consulting Fees
- Underwriter compensation

The profits made by underwriters are referred to as the spread. The spread is the difference between the price the underwriter pays the issuer for the bonds and the price the underwriter receives from the resale of those bonds to investors. The cost of issuing the debt will be expensed in the governmental fund and allocated to the projects approved for the corresponding fiscal year. Underwriter's compensation consists of takedown, management fee, underwriting risk, and expenses, although currently spreads reflect the amounts of only takedown and expenses. The expense component is made up of costs incurred by the underwriter on behalf of the issuer. The costs for these services need to be managed, through the competitive bid process use to select underwriters and subsequent negotiation and monitoring of fees.

Budget: The budget for debt service will be the gross debt service to include interest, and principal.

Refunding of Outstanding Debt: Refunding will only be done if there is a resultant economic gain regardless of whether there is an accounting gain or loss, or a subsequent reduction or increase in cash flows.

Refunding Policy

The Director of Finance and Investments and the Financial Advisor will monitor the municipal bond market for opportunities to obtain interest savings by refunding outstanding debt. As a general rule, the present value savings of a particular refunding should meet 2%/3% tests (individual maturity/overall PV), with certain exceptions, such as the bonds to be refunded have restrictive or outdated covenants, or restructuring debt is deemed to be desirable.

Limitations on Maturity

The State of Vermont normally will issue bonds with maturities of 20 years for general obligation bonds. The State of Vermont will seek to structure debt with level principal and interest costs over the life of the debt. An exception to this is the Citizens Bonds issued with the longest maturity of 10 years. For the purposes of meeting the declining principal amortization requirement, however, the Citizens Bond is often deemed integrated with the preceding general obligation bond (within acceptable date period) such that the combined amortizations are equal or declining.

Statutory Limitation

Bonds are issued at the discretion of the State Treasurer with the approval of the Governor. The State has no constitutional or other limit on its power to issue obligations or incur indebtedness besides borrowing only for public purposes. The Capital Debt Affordability Advisory Committee provides a recommendation to the Governor and the legislature on the maximum amount of new long-term general obligation debt that prudently may be authorized for the next fiscal year. Although advisory, the capital budget appropriated by the General Assembly has followed this recommendation.

Investment of Bond Proceeds

All general obligation and revenue bond proceeds shall be invested in separate bond accounts by issuance to aid in calculating arbitrage. Investments will be consistent with those authorized by existing statute and by the State of Vermont's investment policies.

## Sale Process

State Statute 32 VSA § 953 states that the State Treasurer, with the approval of the Governor, may sell "bonds at such prices, in such amount, at such times and in such manner, with or without advertising the same, as he or she shall determine to be for the best interests of the state, at public or private sale."

A competitive bond offering involves bid solicitation from potential purchasers, principally underwriters. It is a public auction where the bonds are sold to the underwriter or other purchaser that offers the best bid, i.e. the lowest "true interest cost" or TIC. TIC is defined as the rate, compounded semi-annually, necessary to discount the amounts payable on the respective principal and interest payment dates to the purchase price received for the new issue securities. TIC computations produce a figure slightly different from the "net interest cost" or NIC method, since TIC considers the time value of money while NIC does not (see MunicipalBonds.com and Oregon Bond Manual). A negotiated offering differs from a competitive offering in the method used for selecting the underwriter, the role of the underwriter in the bond marketing process, and the procedures used for determining interest rates and underwriter compensation. In a negotiated offering, the underwriter is selected first, often through the solicitation of competitive requests for proposals (Leonard 1994, 15, cited in Stevens, Evaluation of Underwriter proposals for negotiated Bond Offerings, p 440). The underwriter or senior underwriter will engage in pre-sale marketing and will negotiate interest rates.

The State of Vermont will generally conduct financings, wherever feasible, on a competitive basis. However, negotiated financings may be used due to market volatility or the use of an unusual or complex financings or security structure. Retail issues such as the Citizen’s bonds are done through a negotiated process. Also, bond refunding is often conducted through a negotiated process, due to complexities associated with refunding economics and escrow structuring.

In either case, there is still a competitive process, in the first case, by virtue of the auction of the bonds and in the latter case by an RFP process to select an underwriter firm or firms. The negotiated offering is structured to require the solicitation of multiple underwriter proposals and permits the state to solicit the advice of several underwriters about how to structure and price a proposed bond issue.

Either method of sale requires the preparation of an extensive disclosure document which the. Treasurer's Office prepares with the Agency of Administration, Department of Finance & Management, and other department input with the assistance of outside legal counsel. Similarly, both methods of issuance require financial structuring in terms of amount, maturities, call provisions, etc. While these tasks require extensive attention, they are beyond the scope of this description. Overviews of the two methods of issuance are outlined below.

Competitive Sale

After disclosure documents are completed and structuring issues have been decided, the competitive sale process may begin. A Summary Notice of Sale is published in the Bond Buyer alerting potential bidders to the date and time of the sale, approximately one week in advance of the sale date. Simultaneously, the state prints and distributes its Preliminary Official Statement that contains a detailed Notice of Sale containing the relevant aspects of the sale including precise bidding rules. At the appointed date and time, bidders submit their bids on the Official Bid Form. Recent auctions have used an on-line bidding platform developed and maintained by Parity. Bids are promptly “opened” and disclosed. As a condition of submitting a bid, bidders must provide a good faith pledge, typically 1% of the value of the bonds being offered. Approximately one week after the bid, after various legal documents are completed, including the preparation of the bonds themselves and a Final Official Statement, the bond sale closes.

Negotiated Sale

When the senior manager, the underwriting group and the State, with the assistance of the Financial Advisor, determine that market conditions are appropriate, a sale date is chosen. Interest rate scales are solicited from the underwriting group in the days prior to the sale to help determine an initial offering scale for the day of the sale. Prior to the official pricing date, a retail order period may be held to solicit smaller orders from individual investors. On the day of the sale an interest rate scale is made known to potential investors through a pricing wire. An order period is conducted lasting several hours. During the order period, orders are placed by investors through the senior manager, the co-managers and selling group. After the order period closes, the senior manager and state officials review the "book of orders." Based on the amount and distribution of orders, the senior manager and the state determine whether any adjustments to the pricing of the bonds are necessary. After the bonds are repriced, the management group checks to see whether additional orders can be obtained and/or whether initial orders are withdrawn.

Several iterations of this process may take place. When the senior manager (on behalf of the entire underwriting group) and the state agree on a price, a verbal award is made. Subsequent to pricing, an official Bond Purchase Agreement is signed between the underwriting group and the State. A good faith deposit is obtained, similar to the competitive process. On a date specified, after all legal documentation has been completed, the sale closes. The final purchase price of the bonds is wired to the State and the bonds are released, as with the competitive process.

Additional Documentation

The descriptions included above necessarily skip over a number of aspects of the issuance and sale of Vermont bonds. Extensive legal documentation of each is sale is included in the Closing Binder for each sale. These documents, many of which are required under state and federal law, or as a matter of industry practice, are prepared and reviewed in conjunction with a law firm that acts as Bond Counsel. The State Treasurer's Office periodically selects a firm to act as Bond Counsel through a competitive RFP process.

Business Partners/Professional Services

The State of Vermont employs outside financial specialists to assist it in developing a bond issuance strategy, preparing bond documents, and marketing bonds to investors. The key players in the State of Vermont's financing transactions include its financial advisor, bond counsel, underwriter (in a negotiated sale) and in some instances a disclosure counsel. Other outside firms, such as those providing paying agent, trustee, and/or printing services, are retained as required. A review of the primary partners is outlined below.

Bond Rating Goals

The State of Vermont will seek to maintain and, if possible, improve the current ratings in order to minimize borrowing costs and preserve access to credit.

Disclosure

The State of Vermont is committed to continuing disclosure of financial and pertinent credit information relevant to the State of Vermont's outstanding securities and will abide by the provisions of Securities and Exchange Commission (SEC) Rule 15c2-12 concerning primary and secondary market disclosure.

Rating Agency Relations

Full disclosure of operations and open lines of communication shall be made to the rating agencies. State of Vermont staff, with the assistance of the financial advisor, shall prepare the necessary materials and presentation to the rating agencies. Credit ratings will be sought from Moody's, Standard and Poor's, and Fitch as recommended by the State of Vermont's financial advisor.

## Business Partners: [1]

Financial Advisor

The state's financial advisor has traditionally advised the state in structuring the issuance and sale of all bonds, notes, and other securities as well as providing assistance and analyses for other financings, including negotiating terms and drafting documents, legislation, regulations, and procedures. The financial advisor acts as a liaison between the State and bond rating agencies. In addition, the Financial Advisor is responsible, in conjunction with Treasury staff, for analyses, drafting, and presentation of the State of Vermont's Capital Debt Affordability Advisory Committee Report.

Trustee/Paying Agent

The trustee/paying agent is usually a commercial bank (Chittenden). Its purpose is to represent and protect the interest of the bondholders and also to act as paying agent (responsible for transmitting payments of interest and principal from an issuer of municipal securities to the bond holders). The bank provides various other services, including the maintenance of records and reconcilement. In a typical Vermont issue, which generally do not have either a trustee or indenture, there is no trustee and the bank acts as a paying agent.

Depository Trust Corporation (DTC)

DTC is a securities depository and a national clearinghouse, registered with the SEC that provides immobilization, safekeeping and book-entry settlements in corporate and municipal securities. It is a user-owned company. Trustees and paying agents make a single interest and principal payment per maturity to DTC, and DTC distributes those payments to participating banks and securities firms for the benefit of their clients.(Source: California Debt and Investment Advisory Commission, Debt Issuance Primer Handbook)

Underwriter (Investment Banker)

The underwriter is a broker/dealer or investment banking organization that purchases and resells the bonds on behalf of the issuer with the intent of making a profit. In a competitive sale, the issuer is responsible for the planning and design of the bond offering. The issuer solicits sealed bids from competing underwriters for the purchase of bonds. The issuer (State), with the assistance of the financial advisor, plans the amount, structure and other parameters of the sale independent of the underwriter. In a negotiated sale, the underwriter takes on a more active role with the timing and pricing and is usually engaged at the beginning of the bond issuance cycle. The underwriter then purchases the bonds on terms mutually agreeable to the issuer and underwriter. In the Vermont model, an RFP is issued to solicit underwriters

Syndicate

(1) See various sources including: KUTAK ROCK LLP, Housing Bond Basics, OREGON STATE TREASURY, MUNICIPAL DEBT ADVISORY COMMISSION, BOND MANUAL, California Debt and Investment Advisory Commission, Debt Issuance Primer Handbook

A group of underwriters organized for the purposes of sharing the risks of underwriting the issue, obtaining sufficient capital to purchase an issue and broadening the distribution channels of the issue to the investing public. One of the underwriting firms will be designated as the syndicate senior manager or lead manager to administer the operations of the syndicate.

Bond Counsel

Every municipal security must be reviewed by a lawyer or law firm known as bond counsel. The legal opinion is an authorization of the debt and covers two main issues:

- It ensures that the bonds are legal, valid and binding obligations of the issuer.

- It verifies the tax status of the debt; that is, interest on the bonds is exempt from federal income taxes (as well as state and local taxes in some cases).

Investors will not buy municipal bonds unless there is an opinion of a recognized law firm to the effect that the bonds are validly issued and the interest on the bonds is tax-exempt. Bond counsel also should be experienced with all aspects of structuring a financing and should advise the issuer and the underwriter on the legal aspects of the bond issue.

State Economist

This individual provides economic and demographic data for the Official Statement and for rating agency presentations, and CDAAC report.

Underwriter's Counsel

An attorney or law firm retained to represent the interests of an underwriter in connection with the purchase of a new issue of municipal securities. The duties of underwriter's counsel may include review of the issuer's bond resolution and documentation on behalf of the underwriter; review of the accuracy and adequacy of disclosure in the official statement; preparation of the agreement among underwriters, Contract of Purchase and/or the official statement; assisting the underwriter in meeting the underwriter's due diligence obligation; and delivery of a due diligence opinion.

Credit Rating Agencies

These include Moody's Investors Service, Inc., Standard and Poor's Corporation and Fitch Investors Service. Rating agencies appraise, analyze and monitor the credit quality of a bond issuer. These firms provide credit ratings for use by retail and institutional investors to gauge the credit risks inherent in the bond issue. The fee for the rating service is paid by the issuer and based on the issue size, type, and complexity.

Office of the Attorney General

This Office provides a review of contingent liabilities including legal proceedings against the state as part of disclosure to bond holders. Works with the bond counsel.

Department of Finance & Management,  Auditor of  Accounts, Secretary of State, Agency of Administration, other  State Agencies and Departments.

Provide the financial statements and financial and demographic information necessary to enable the preparation and filing of bond documents and continuing disclosure and/or approve documents as to form.

Financial Operations Division, Department of Finance & management

Monitors, projects, and controls expenditures on capital projects funded through bonds issued by the Treasurer. Provides information for the State's official Statement (see below).

## **Disclosure and Post Issuance Debt Management**

Municipal securities are exempt from the disclosure regulations generally applied to corporations in both the Securities Act of 1933 and the Securities Exchange Act of 1934.  Municipal securities, however, are subject to the anti-fraud provisions of the acts and related rules (Olson, 2007), specifically, section 17(a) of the 1933 Act, Section 10(b) of 1934 Act, and SEC Rule 10b-5. Rule 10b-5 states that it is unlawful "to make an untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." As the issuer of the bonds, the State has the responsibility to assure the accuracy and completeness of information provided to the potential investors. Issuers such as the State must also comply with SEC Rule 15c2-12. It is an SEC rule under the 1934 Act "setting forth certain obligations of underwriters to receive, review and disseminate official statements prepared by issuers of most primary offerings of municipal securities." (MSRB Web site)

The State issues a preliminary and final Official Statement (OS) in connection with its bonds. The Official Statement is one of the most critical documents produced by the bond team. The OS document discloses material information on a new issue including the purposes of the issue, how the securities will be repaid, and the financial, economic and demographic characteristics of the State. Investors, analysts and rating agencies may use this information to evaluate the credit quality of the securities. Federal securities laws generally require that if an official statement is used to market an issue, it must fully disclose all facts that would be of interest to potential investors evaluating the bonds. The OS also includes a statement that there have been no material misstatements or omissions by the issuer with respect to the issue, and that no facts have become known which would render false or misleading any statement which was made. Appendix 2 B identifies the key players and responsibilities in producing this document. While the State employs consultants and bond counsel to assist in this task, the ultimate responsibility for the document rests with the State.

After the bonds are issued the State has continuing obligations to bondholders including:

- Payment of principal and interest on their securities
- Compliance with IRS code relative to arbitrage earnings, private use, useful life and the tax-exempt status of the bonds; and
- Continuing disclosure to bondholders about material events that affect the status of the bonds including arbitrage and tax compliance.

The obligation to pay the debt service is straightforward and covered in the Procedures Manual. A risk map with a brief overview of the process and a summary of the procedures is included in the Appendix to this document. The emphasis of this review is IRS and continuing disclosure, which lead to extensive risk management considerations for bonds.

The primary IRS code applicable to tax-exempt bonds are the Federal Tax Reform Act of 1986 as incorporated in the U.S. Treasury Internal Revenue Code (IRC) sections 103 and 141 through 150. While there are many criteria, the most common issues relate to private use, arbitrage, and useful life. Section 103 of the Code indicates that an "arbitrage bond" under Section 148 will not be tax-exempt. "The basic arbitrage rule is that a municipality may not invest the proceeds of a tax-exempt note or bond in such a manner so that the yield on the invested funds exceeds the interest rate being paid on its borrowing by more than .125%. If this rule is violated and the municipality does not qualify for an exception to this rule, its borrowing will be an "arbitrage bond" and consequently will not be tax-exempt under Section 103 of the Code. An arbitrage bond would include any bond issue for "which any portion of the proceeds is reasonably expected, at the time of issuance, to be used to acquire higher yielding investments, or to replace funds which were used to acquire higher yielding investments." (Shannon, et. al, 2007) As such, the issuer will not be able to take advantage of the below-market interest rates that are typically available to municipal borrowers." (VLCT, 2005) This should be distinguished from an unintentional generation of arbitrage earnings. Intent factors into the determination of "arbitrage." If projects fall behind schedule, there may be an arbitrage "rebate' to the IRS but not necessarily a determination that an arbitrage bond exists. In these cases, there are safe harbors such as spend down exemptions and there are certain requirements for tracking the arbitrage rebate. Intentional arbitrage would, however, affect the status of the bonds.

In addition to arbitrage, another requirement is that the bonds issued must be for a public, not private use, generally bridges, schools, infrastructure used by the general public. There are, however, private uses that have a public benefit; pollution related clean-up, affordable housing, etc. Private use and private debt service of the bond cannot exceed10% of the issue (5% on certain loans). [2]Another issue is continued private use. For instance, a building constructed using bond funds for a public use may not generally be resold for private use, although the "change in use" provisions do provide for certain remedies. In addition, bonds may not exceed certain useful life criteria for the underlying capital assets.

At the time of issuance, disclosure of material facts is made. Issuers such as the State have a continuing obligation for disclosure. This is required by SEC Rule 15c2-12 as stated by the MSRB:

[2] See also separate discussion of Private Activity Bonds and cap in the Appendices to the Procedures Manual.

> "Under Rule 15c2-12(b)(5), an underwriter for a primary offering of municipal securities subject to the rule currently is prohibited from underwriting the offering unless the underwriter has determined that the issuer or an obligated person for whom financial information or operating data is presented in the final official statement has undertaken in writing to provide certain items of information to the marketplace. Rule 15c2-12(b)(5) provides that such items include: (A) annual financial information concerning obligated persons; (B) audited financial statements for obligated persons if available and if not included in the annual financial information; (C) notices of certain events, if material; and (D) notices of failures to provide annual financial information on or before the date specified in the written undertaking." (MSRB Notice 2008-33)

The SEC further defines "obligated person" as:

> "… any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all or part of the obligations on the municipal securities sold in a primary offering (other than providers of bond insurance, letters of credit, or other liquidity facilities)." (MSRB Notice 2008-33)

The SEC further requires that broker-dealers can only buy securities for which the issuer has agreed to provide written assurance of their continuing disclosure. As noted above, the SEC does not have authority over disclosure requirements in the municipal bond market. Through these rules, however, the SEC has placed restrictions on underwriters, broker-dealers and other business partners, creating effective compliance. (WM Financial Strategies, 2005)

SEC Rule 15c2-12 mandates continuing disclosure unless the bonds qualify for an exemption, which is generally not the case given the size of the Vermont issues. The Director of Finance and Management is responsible for providing ongoing disclosure information to established national information repositories and for maintaining compliance with disclosure standards promulgated by state and national regulatory bodies. This individual works with Bond Counsel to assure that this is completed annually and in the event of the occurrence of a disclosure event. Notice would be required for the following events:

- Principal and interest payment delinquencies
- Non-payment related defaults
- Unscheduled draws on the debt service reserves reflecting financial difficulties
- Unscheduled draws on the credit enhancements reflecting financial difficulties
- Substitution of the credit or liquidity providers or their failure to perform
- Adverse tax opinions or events affecting the tax-exempt status of the bonds
- Modifications to rights of bondholders
- Optional, contingent or unscheduled calls of bonds
- Defeasances
- Release, substitution or sale of property securing repayment of the bonds

- Rating changes

Annual filings are to be sent to all existing nationally recognized municipal securities information repositories (NRMSIRs). In addition, if the State determines that the occurrence of an above listed event is material under applicable federal securities laws, the State has a duty to promptly file a notice of such occurrence with the NRMSIRs and Municipal Securities Rulemaking Board. A listing of the current repositories is provided in the Procedures Manual and can also be found at http://www.sec.gov/info/municipal/nrmsir.htm.

## Risk Management

### Risks to Investors:

Certain risks accrue to the purchaser of bonds. While these are not direct risks to the State, and are not included in the more detailed risk assessment, they do have an impact on the marketability of the bonds. As such, they are included in considerations around bond structure and pricing. These include:

#### Credit Risk

Credit risk is the likelihood that a bond issuer's ability to pay debt service (principal and interest) will be impaired in the future. Bond ratings provide some measure of credit risk. A bond's rating is generally based on an analyst's assessment of the credit quality of an issuer at the time the rating was published. However, unanticipated future events may change the perceived credit quality and rating of the issuer. A bond's value will generally increase with a rating improvement while its value will generally decrease with a rating downgrade. The State’s efforts to maintain high credit ratings through the Capital Debt Affordability process and through open communication with credit rating agencies, mitigates this risk.

#### Market/Interest Rate  Risk

Market risk involves an investor's exposure to changing market conditions. Because a bond entitles its holder to fixed payments of interest in the future, the price of a bond will vary inversely with changes in interest rates. A fundamental principal of fixed income securities is that as the price goes down, the yield on a security goes up.  When interest rates rise, a bond's value declines. Alternatively, if interest rates drop, the bond's value increases.  Absent a default or call, however, a municipal bond will return its stated par value at maturity. The inverse relationship between interest rates and bond prices holds for all fixed rate bonds, regardless of the complexity of their interest payment structure. Additionally, market fluctuations will alter the interest rate environment for the reinvestment of interest payments. While overall market conditions are outside of the control of the State Treasurer’s Office, timing, term and rate structure of the bond are considerations in issuance.

#### Call Risk

Call risk exists in bonds that are subject to an optional call. A call provision allows the issuer to repay a bond's principal, often at a premium to par, on or after a date but prior to the maturity date. If interest rates drop significantly during the life of the bond, the issuer may decide to exercise the call option and repay the principal. The issuer then issues new bonds at the lower rates. This is similar to homeowners refinancing mortgages when interest rates drop. Early repayment adversely affects bond investors because they must reinvest their principal in a lower interest rate environment. Because of these market concerns, the investor is generally compensated for this but the calculations on this risk are difficult to determine due to cash flow considerations. It also exposes the investor to market risk.

## Risk Accruing to Both Issuer and Purchaser

Tax-Exempt Status:

Municipal bonds are generally attractive because of their tax-exempt status. Interest on many municipal securities is exempt from federal income taxation pursuant to Section 103 of the Internal Revenue Code, and may or may not be exempt from state income.

To qualify for tax-exemption, municipal securities must be and remain in compliance Federal tax laws and regulations. Failure to maintain the tax-exempt status of the bond through a violation of covenants or IRS code would have significant adverse financial impacts on the bondholder and would severely limit the state’s ability to issue future bonds. All credibility in the market would be lost. One of the requirements is that the bonds issued must be for a public, not private use, generally bridges, schools, infrastructure used by the general public. Some uses get a bit foggier; loans programs for environmental cleanup, generally, private use and private debt service of the bond cannot exceed10% of the issue (5% for some elements such as certain loans). In structuring a bond issue the State needs to be careful to avoid private use as much as possible. Bond counsel reviews each proposed use of the capital project appropriations with the department of Finance & management to determine if the use should be classified as public or private.

Due Diligence, Disclosure and Adverse Conditions

As the issuer of the bonds, Vermont has an obligation to assure that investors receive an accurate picture of the State and the nature of the bonds to be sold and receive any information on material events that might affect the status or marketability of the bonds. This issue was reviewed in the previous section. Lack of compliance can have serious repercussions including, but not limited to:

- Detrimental impact on the marketability of future bonds
- Tax consequences to the State and bondholders
- Penalties and fines
- Legal action by bond holders against the State
- Inability to reenter the bond market

As noted previously, the Director of Finance and Investments, assisted by Bond Counsel, is responsible for providing ongoing disclosure information to established national information repositories and for maintaining compliance with disclosure standards promulgated by state and national regulatory bodies. This individual works with bond counsel to assure that this is completed annually and in the event of the occurrence of a disclosure event. The National Association of Bond Lawyers (NABL) and the Government Finance Officers Association (GFOA) developed and issued a Post Issuance Compliance Checklist to assist bond counsel and issuer staff in identifying and monitoring disclosure. A copy of this document is included in the Procedures Manual.

## Contractual and Operational Risks

### Qualified Firms (Bond Counsel, Financial Advisor, Underwriter)

In order to maintain a successful debt management program, the quality of the financial and legal advice is critical. The Government Finance Officers Association (GFOA) Recommended Practices (see listing below) provide guidance on the selection of qualified bond counsel, financial advisors, and underwriters. In all cases, the recommendations include selection on the basis of merit, the use of a competitive process, and periodic review those relationships. The State uses a well documented Request for Proposal (RFP) process that assures periodic review to compare qualifications of firms and select a firm or firms that best meets the needs at the best overall value. Fees and compensation are important factor in the evaluation of responses; however, the Office of the State Treasurer selects the bid that demonstrates the "best value" overall, including proposed alternatives, that meet the objectives of the procurement.

### Independence of Financial Advisor/Underwriter:

The Financial Independence of a financial adviser (see business partners above) is essential to the bond issuance process. Some firms providing these services also have an underwriting unit and, in some cases, firms hired as financial advisors subsequently provide underwriting services. While the Treasurer's Office recognizes that there reasons that industry professionals believe justify consideration of a dual role, such as the existence of complex issues associated with a deal, the size of the deal and economies of scale or unusual market events, the Office takes the position that the roles should be independent to avoid conflict and protect the interest of the state, whenever possible.. As noted below:

> "The role and interests of a securities professional acting as financial advisor to a governmental unit are significantly different from the role and interests of a securities professional acting as an underwriter or as a purchaser in a private placement. For example, as agent for the issuer, a financial advisor would normally seek to achieve the lowest possible interest cost for the issuer, while an underwriter, acting as principal for its own account, would normally want to establish yields which make the securities attractive for

resale to others." (source: WM Financial Strategies, "Rule G-23 of the Municipal Securities Rulemaking Board," www.munibondadvisor.com)

The Municipal Securities Rulemaking Board (MSRB) rule governing this, G-23, establishes ethical standards and disclosure requirements for brokers, dealers, and municipal securities dealers who act as financial advisors to issuers of municipal securities. Among other provisions, it recognizes an inherent conflict between advisor and underwriter but provides that a financial advisor may resign and then either bid on the bonds in a competitive sale, or serve as the underwriter in a negotiated sale (http://www.msrb.org/msrb1/rules/ruleg23.htm). The GFOA, in its best practices statement (source: GFOA Recommended Practice Selecting and Managing the Method of Sale of State and Local Government Bonds (1994 and 2007), recommends a practice beyond this rule:

- "Due to inherent conflicts of interest, the firm acting as a financial advisor for an issuer should not to be allowed to resign and serve as underwriter for the transaction being considered."

- "Due to potential conflicts of interest, the issuer should also enact a policy regarding whether and under what circumstances it will permit the use of a single firm to serve as an underwriter on one transaction and a financial advisor on another transaction."

The Treasurer's Office Financial Advisor does not have an underwriting capacity or function, thus eliminating this risk.

<u>Other Operational Risks</u>

The issuance of debt requires that principal and interest be paid to the bondholders on schedule and in the correct amount. A violation of the terms of repayment would constitute bond default. Such bond default could arise from a missed scheduled payment or through inadequate cash to pay funds. Since there are critical impacts in terms of the bondholders and reputation risk associated with such a default that would severely damage Vermont's ability to re-enter the bond market, multiple scheduling prompts are used to verify that payments are executed in a timely manner. In addition, bond costs must be appropriate to the issue. A separate bond issuance account is appropriated to identify and include all costs in the appropriation for debt issuance, provide an accurate allocation of debt service costs, and to verify that all bond issuance costs submitted for payment to the State of Vermont are valid and accurate.

## **<u>Web Resources: Bond issuance and Management</u>**

| | |
|---|---|
| National Association of Bond Lawyers | http://www.nabl.org/ |
| The Bond Buyer | http://www.bondbuyer.com/ |
| Municipal Securities Rule Making Board (MSRB) | http://www.msrb.org |
| National Federation of Municipal Analysts (NFMA) | http://www.nfma.org/ |

| | |
|---|---|
| GFOA Public Policy Statements - Debt Management | http://www.gfoa.org/services/policy/ |
| Securities Industry and Financial Markets Assoc.* | http://www.sifma.org/ |
| CUSIP Service Bureau | http://www.cusip.com |
| The Council of Development Finance Agencies | http://www.cdfa.net/ |
| National Association of State Treasurers | http://www.nast.net/ |
| Securities and Exchange Commission | http://www.sec.gov/ |
| NRMSIRs listing | http://www.sec.gov/info/municipal/nrmsir.htm |
| MRSB/EMMA** | http://emma.msrb.org/default.aspx |
| E-Muni (Electronic Municipal Statistics) | http://www.emuni.com/ |
| Muni IRIS, DPC Data | http://www.muniiris.com/iris/s_iris.cfm |

*The Bond Market Association merged with the Securities Industry Association to form the Securities Industry and Financial Markets Association.
** Electronic Municipal Access (Official Statements and trade Data)

## Best Practices

The Government Finance Officers Association has issued a series of recommended practices related to debt management. These include:

- Analyzing an Advance Refunding (1995)
- Payment of the Expense Component of Underwriters' Discount (1996)
- Preparing RFPs to Select Financial Advisors and Underwriters (1997)
- Sale and Securitization of Property Tax Liens (1997)
- Using Variable Rate Debt Instruments (1997)
- Issuer's Role in Selection of Underwriter's Counsel (1998)
- Issuing Taxable Debt by U.S. State and Local Governments (1998)
- Pricing Bonds in a Negotiated Sale (1996 and 2000)
- Underwriter Disclaimers in Official Statements (2000)
- Using a Web Site for Disclosure (2002)
- Debt Management Policy (1995, 2003)
    - Post Issuance Compliance Checklist
- Maintaining an Investor Relations Program (1996, 2003)
- Evaluating the Use of Pension Obligation Bonds (1997, 2005)
- Secondary Market Securitization of Tax-Exempt Obligations (1993, 1996, 2005)
- Use of Debt-Related Derivatives Products and the Development of a Derivatives Policy (1995, 2003, 2005)
    - Derivatives Checklist

- Auditor Association with Financial Statements Included in Offering Statements or Posted on Web Sites (2005, updated 2006)
- Tax Increment Financing as a Fiscal Tool (2006)
- Debt Service Payment Settlement Procedures (2003, 2007)
- Investment of Bond Proceeds (1996 and 2007)
- Need for Considerable Caution in Regard to OPEB Bonds (2007)
- Selecting and Managing the Method of Sale of State and Local Government Bonds (1994 and 2007)
- Selecting Bond Counsel (1998 and 2008)
- Public-Private Partnerships for Economic Development (2008)

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# Appendices

Appendix #1- Risk Narratives and Maps

A. Receipt of Bond Proceeds
B. Bond Default- Payment Related
C. Bond Default- Technical Default
D. Bondholder Adverse Action
E. Tax-Exempt Status of Bonds
F. Arbitrage Rebate
G. Bond Issuance Costs
H. Selection of Bond Counsel, Financial Advisor and Underwriter

Appendix #2- Bond Financing Flow Charts and Schedules

A. Bond Issuance Flowchart
B. Bond Document Preparation Schedules and Responsibilities

Appendix #3 - Bond Related Procedures, Office of the State Treasurer (note: additional materials and procedures are included in separately issued Procedures Manual)

Appendix #1

Risk Narratives and Maps

**Internal Control**

**Debt Management**

**Receipt of Bond proceeds**

Office of the State Treasurer

**Purpose:**
When bonds are issued, the State, as the borrower, takes possession of bond proceeds. These funds are then used to pay the expenses of capital projects. This must be done in an accurate and timely manner.

**Risk Assessment:**

- Risk is deemed medium. While the impact is critical, the likelihood is extremely low as the successful bidder/underwriter/syndicate would suffer market reputation. DTC practice and MSRB rules also provide the framework for the conduct of underwriters in settlement.

**Internal Control Objectives:**

- To ensure the State receives, in a timely manner, all funds it is due resulting from the sale of a bond issuance.
- To properly record the bond transaction.

**Control Activities/Risk Mitigation**:

- Prior to Sale:
  - Cash management projections are utilized to establish cash/bond proceed needs well in advance of actual needs (see cash management internal controls)
  - Bond disclosure documents detail procedures for the transaction in either a competitive of negotiated sale.
- Competitive Sale:
  - The debt is offered electronically through an online bidding service
  - All bidders agree to the terms and conditions of the sale through the use of a standardized bid form.
  - The auction is conducted and the winner or winners are notified immediately by the auction administrator. The winning firm or firms are then contacted to provide confirmation.
  - Each bid must be accompanied by a certified or cashier's check or good faith pledge, typically 1% of the value of the bonds being offered, drawn upon an incorporated bank or trust company authorized to transact business in the State of Vermont or in the City of New York and payable unconditionally to the order of the State of Vermont to secure the State against any loss resulting from the failure of the successful bidder to comply with the terms of its bid. In lieu of the check, the deposit may be in the form of a financial surety bond. The check of the successful bidder will be deposited and credited toward the purchase price, and no interest will be allowed thereon to accrue to the benefit of the successful bidder. The proceeds of the check will be retained by the State as liquidated damages in case the successful bidder fails to accept delivery of and pay for the Bonds. Checks of unsuccessful bidders will be returned promptly upon award of the Bonds. If the bonds are awarded to a bidder utilizing a financial surety bond, then such successful bidder is

required to submit its deposit to the State in the form of a cashier's check or certified check or wire transfer on the next business day following the award. If such deposit is not received, the financial surety bond may be drawn by the State to satisfy the deposit requirement.

- Bond settlement is conducted through DTC (see overview and flow charts) and certified per established procedures by MSRB and DTC. Closing documents include the Treasurer's "Certificate as to Delivery, Receipt of payment and Specimen Bond" and the underwriter's "Receipt for Bond Documents; Evidence of payment" and the trustee's "Representations as F.A.S.T Agent; Receipt for the Bonds'
- A Closing Memorandum is issued to identify steps for execution (see Procedures Manual) that preclude delivery of bonds prior to receipt of funds.

- <u>Negotiated</u> Sale:
  - In a negotiated sale a syndicate of investment banking firms is assembled with one of the firms acting as the book running senior manager. Once the bonds are priced, a "Contract of Purchase" is signed by the underwriting group and the State Treasurer and the total amount due the State of Vermont is stated in the agreement.
  - Bond counsel prepares a Closing Memorandum which summarizes the final amount to be paid to the State.
  - A good faith bond or check, similar to above, is required, except that generally the check is not deposited (unless failure of underwriter to accept and pay for the bonds) and is returned to the underwriter upon closing..
  - If an underwriting syndicate is formed, an "Agreement Among Underwriters" (AUU) identifies the instructions and terms.
  - Bond settlement is conducted through DTC (see overview and flow charts) and certified per established procedures by MSRB and DTC. Closing documents include the Treasurer's "Certificate as to Delivery, Receipt of payment and Specimen Bond" and the underwriter's "Receipt for Bond Documents; Evidence of payment" and the trustee's "Representations as F.A.S.T Agent; Receipt for the Bonds"
  - A Closing Memorandum is issued to identify steps for execution (see Procedures Manual) that preclude delivery of bonds prior to receipt of funds.

- <u>Settlement Standards</u>: MSRB Rule G-12 (Uniform Practice Code) rule covers the following matters:
  - establishment of uniform settlement dates for transactions in municipal securities;
  - exchange and comparison of dealer confirmations;
  - procedures for resolving discrepancies in confirmations which result in unrecognized transactions;
  - establishment of uniform requirements for good delivery of municipal securities;
  - procedures for rejection and reclamation of municipal securities;
  - close-out procedures for transactions in municipal securities; and
  - the time periods within which good faith deposits must be returned, syndicate accounts settled, and credits from designated orders distributed.

**Process:** See debt overview document and procedures in this manual. For additional detail, please reference the Debt Section of the Procedures Manual.

## Office of the State Treasurer
## Internal Control Risk Map

Risk Title: Receipt of Bond Proceeds

Risk Description: Bond proceeds are not received, not received in a timely manner, or not in an amount consistent with terms.

Risk Category: Operational

Strategic | Financial | Statutory / Regulatory | Operational | Human Capital | Technological

Enter Impact Rating: 5 Enter Likelihood Rating: 1

Risk Rating: 5 Risk Level: Medium

| Impact | | | | | | |
|---|---|---|---|---|---|---|
| | 5 | Critical | 5 | | | |
| | 4 | Serious | | | | |
| | 3 | Moderate | | | | |
| | 2 | Minor | | | | |
| | 1 | Negligible | | | | |
| | | | Improbable | Possible | Probable | Near Certain |
| | | | 1 | 2 | 3 | 4 |
| | | | Likelihood | | | |

**Internal Control**

**Debt Management**
**Bond Default- Payment**
Office of the State Treasurer

**Purpose:**
The issuance of debt requires that it be principal and interest be paid to the bondholders on schedule and in the correct amount. A violation of the terms of repayment would constitute bond default. Such bond default could arise from a missed scheduled payment or through inadequate cash to pay funds.

**Risk Assessment:**

- Risk is deemed high as the consequences of bond default seriously impact the credit rating of the state, its reputation in the financial markets, and the ability to issue future bonds, capital leases and/or shot-term debt.

**Internal Control Objectives:**

- To identify all applicable terms of bond repayment and assure compliance.
- To provide back-up systems to assure that all payments are made in a timely manner.
- To assure cash assets are available to pay the debt service.
- To accurately pay all invoices for payment in a timely manner.

**Control Activities/Risk Mitigation**:

- The Debt service schedule is incorporated in the final Official Statement document and other bond documents and is reviewed for accuracy by the Treasurer's Office Director of Finance and Investments, the state's Financial Advisor, and underwriters.
- Separate schedules are maintained by the Paying Agent (Chittenden Bank) and the Treasurer's office, Treasury Operations Division. In addition, the debt service is posted to the cash projection worksheets.
- Paying Agent provides advance notification (invoices) of the pending debt service payment. These are compared to the schedule maintained by the Cash and Investments Manager.
- Cash flow projections are routinely completed to assure funds are available (see cash management internal control)
- The State maintains a line of credit with its bank of record (TD Banknorth) in the unlikely event that funds are not available

**Process:**

See debt overview document and procedures.

## Office of the State Treasurer
## Internal Control Risk Map

Risk Title: Bond Default- Payment

Risk Description: Missed scheduled payment- inadvertent and/or cash inadequacy

Risk Category: Operational

Strategic | Financial | Statutory / Regulatory | Operational | Human Capital | Technological

Enter Impact Rating: 5 | Enter Likelihood Rating: 3

Risk Rating: 15 | Risk Level: High

| Impact | | | | | | |
|---|---|---|---|---|---|---|
| | 5 | **Critical** | | | **15** | |
| | 4 | **Serious** | | | | |
| | 3 | **Moderate** | | | | |
| | 2 | **Minor** | | | | |
| | 1 | **Negligible** | | | | |
| | | | **Improbable** | **Possible** | **Probable** | **Near Certain** |
| | | | **1** | **2** | **3** | **4** |
| | | | **Likelihood** | | | |

**Internal Control**
**Debt Management**
**Bond Default- Other (Technical Default)**
Office of the State Treasurer

**Purpose:**
Bonds have covenants that must be met to keep them in good standing. Covenants made in connection with a bond issue, depending on the type of issue, include covenants to charge fees for use of the financed project sufficient to provide required pledged revenues (rate covenant); to complete, maintain and operate the project; not to sell or encumber the project; maintain a "public use" as defined by the IRS; and not to take actions which would cause the bonds to be arbitrage bonds. This type of default is different from payment default and is referred to as technical default. If a technical default is not cured within a specified period of time, the bondholders or trustee may exercise legally available rights and remedies for enforcement of the bond contract. There are also disclosure requirements as a result of technical defaults experienced by the industry (not Vermont) in 1970's.

**Risk Assessment:**

- Risk is deemed medium. While an impact of bond default is critical, including the potential of accelerating payment of principal payments, reputation risk in the market, and/or possibly impacting the tax status of the bonds (see separate risk assessment), such an occurrence is deemed improbable, based on the relatively uncomplicated bond structure used by Vermont.

**Internal Control Objectives:**

- To identify all bond covenants and assure compliance at the time of issuance.
- To comply with all bond covenants post issuance
- To make continuing disclosures as required provide back-up systems to assure that all payments are made in a timely manner.

**Control Activities/Risk Mitigation**:

- Because of the limited types of bonds utilized by the State (general obligation debt and refunding), covenants are minimal and not complex.
- Bond Counsel reviews Bonds, Contract of Purchase, Official Statement and other documents to assure compliance and certifies so at the time of issuance and execution.

- The State continues monitoring for compliance with the terms of the bonds including private activity use and arbitrage requirements.

- The Director of Finance and Investments employs a post issuance checklist process as recommended by the Government Finance officers Association and the national Association of Bond Lawyers.

**Process:**

The Official Statement document is the primary means by which the issuer and the offering will become known to potential investors. Therefore, the information presented in the statement must be complete and accurate. Moreover, any adverse condition that could materially affect the sale or servicing of the debt should be fully and clearly disclosed. Disclosure must inform a possible unsophisticated investor about the financial and economic viability of the issuer.

The Director of Finance and management is responsible for providing ongoing disclosure information to established national information repositories and for maintaining compliance with disclosure standards promulgated by state and national regulatory bodies. This individual works with Bond Counsel to assure that this is completed annually and in the event of the occurrence of a disclosure event.

## Office of the State Treasurer
## Internal Control Risk Map

Risk Title: Bond Default- Other

Risk Description: Lack of compliance with bond covenants results in default

Risk Category: Statutory / Regulatory

Strategic | Financial | Statutory / Regulatory | Operational | Human Capital | Technological

Enter Impact Rating: 5 Enter Likelihood Rating: 1

Risk Rating: 5 Risk Level: Medium

| Impact | | | | | | |
|---|---|---|---|---|---|---|
| Impact | 5 | Critical | 5 | | | |
| | 4 | Serious | | | | |
| | 3 | Moderate | | | | |
| | 2 | Minor | | | | |
| | 1 | Negligible | | | | |
| | | | Improbable | Possible | Probable | Near Certain |
| | | | 1 | 2 | 3 | 4 |
| | | | Likelihood | | | |

Internal Control

**Debt Management**
**Bond Holder Adverse Action**
Office of the State Treasurer

**Purpose:**
Providing accurate and complete information material concerning the State, its demographics, economic condition, and finances as well as the bonds itself, are necessary pieces of information a potential investor would be likely to consider important in deciding whether to invest. Full disclosure enables the investor to evaluate the credit quality of an issue. Lack of complete and accurate disclosure or misstatement can result in an adverse action (legal proceedings) by the bond holder(s) or a rating downgrade.

**Risk Assessment:**

- Risk is assessed as medium. While the impact is deemed serious, inkling the cost of legal proceedings and judgments, reputation risk and credit rating, likelihood is less than 50% probability.

**Internal Control Objectives:**

- To provide an accurate and full disclosure in bond documents, including the Official Statement.
- To make continuing disclosures as required provide back-up systems to assure that all payments are made in a timely manner.

**Control Activities/Risk Mitigation**:

- A full finance team, including, financial advisor, the Director of Finance and Investments, the State economist, the department of Finance & Management, and other key department staff, are involved with drafting and finalizing the Official Statement.
- The OS is published and available to all bidders. Underwriters have a requirement to provide this information to prospective purchasers on the bonds.
- Bond Counsel reviews the Bonds, Contract of Purchase, Official Statement and other documents to assure appropriate disclosure and conduct due diligence meetings with key staff.
- Bond documents are reviewed by the Auditor of Accounts.
- The State complies with the continuing disclosure requirements for bonds (see process below)

- The state continues monitoring for compliance with the terms of the bonds including private activity usage, arbitrage requirements.

- The Director of Finance and Investments employs a post issuance checklist process as recommended by the Government Finance officers Association and the National Association of Bond Lawyers.

**Process:**

The State issues a preliminary and final Official Statement (OS) in connection with its bonds. The OS document discloses material information on a new issue including the purposes of the issue, how the securities will be repaid, and the financial, economic and demographic characteristics of the State. Investors, analysts and rating agencies may use this information to evaluate the credit quality of the securities. Federal securities laws generally require that if an official statement is used to market an issue, it must fully disclose all facts that would be of The OS also states that there have been no material misstatements or omissions by the issuer with respect to the issue, and that no facts have become known which would render false or misleading any statement which was made.

As noted above a team approach is used to develop the document with multiple due diligence reviews with the Bond Counsel. The independent Financial Advisor is also involved with the drafting of the document.

The Director of Finance and Management, working with Bond Counsel, is responsible for providing ongoing disclosure information to established national information repositories and for maintaining compliance with disclosure standards promulgated by state and national regulatory bodies.

A list of the types of disclosure events is provided in the “Disclosure and Post Issuance Debt Management” section of the narrative. A post issuance checklist document was recently implemented.

## Office of the State Treasurer
## Internal Control Risk Map

Risk Title: Bondholder Adverse Action

Risk Description: Material misstatement or lack of continuing disclosure results in adverse action by bondholders or rating agency.

Risk Category: Statutory / Regulatory

Strategic | Financial | Statutory / Regulatory | Operational | Human Capital | Technological

Enter Impact Rating: 4 | Enter Likelihood Rating: 2

Risk Rating: 8 | Risk Level: Medium

| Impact | | | | | | |
|---|---|---|---|---|---|---|
| | 5 | Critical | | | | |
| | 4 | Serious | | 8 | | |
| | 3 | Moderate | | | | |
| | 2 | Minor | | | | |
| | 1 | Negligible | | | | |
| | | | Improbable | Possible | Probable | Near Certain |
| | | | 1 | 2 | 3 | 4 |
| | | | Likelihood | | | |

Internal Control

**Debt Management**
**Tax-exempt Status of Bonds**
Office of the State Treasurer

**Purpose:**
Municipal bonds are generally attractive because of their tax-exempt status to qualify for tax-exemption; municipal securities must be and remain in compliance Federal tax laws and regulations.

**Risk Assessment:**

- Risk is assessed as high. Any adverse action affecting the tax status of the bonds would create on overwhelming adverse negative response in the market, affecting the marketability of future issues.

- In the event of an adverse determination by the IRS, the State would likely need to pay fines to maintain the tax status of bonds.

- Even prior to an adverse determination, an issuer of tax-exempt bonds must promptly upon receipt of notification from the IRS of the commencement of a bond audit, and throughout the audit process, evaluate and re-evaluate the obligation and propriety of making disclosure to investors and potential investors regarding the existence and processing of the audit, having negative consequences.

- The existence of an IRS audit of a tax-exempt bond may materially affect the price of the bonds in the secondary market.

**Internal Control Objectives:**

- To assure compliance with all applicable IRS statutes at the time of issuance, as affirmed by Bond Counsel

- To assure continued compliance during post issuance.

**Control Activities/Risk Mitigation**:

- At the time of the issuance of bond, Bond Counsel must give an opinion affirming the tax status of the bonds. Before rendering such an option, due diligence is conducted to assure compliance with various issues (see process below).

- The state continues monitoring for compliance with the terms of the bonds including private activity usage, arbitrage requirements.

- The Director of Finance and Investments employs a post issuance checklist process as recommended by the Government Finance officers Association and the National Association of Bond Lawyers.

**Process:**

As noted in the debt management Overview, section “Disclosure and Post Issuance Debt Management”, an arbitrage bond would include any bond issue for “which any portion of the proceeds is reasonably expected, at the time of issuance, to be used to acquire higher yielding investments, or; to replace funds which were used to acquire higher yielding investments” (Shannon, et. al, 2007). As such, the issuer will not be able to take advantage of the below-market interest rates that are typically available to municipal borrowers” (VLCT, 2005). This should be distinguished from an unintentional generation of arbitrage earnings, which is covered under a separate risk narrative. . Intent factors into the determination of “arbitrage”. If projects fall behind schedule, there may be an arbitrage “rebate’ to the IRS but not necessarily a determination that an arbitrage bond exists. Intentional arbitrage would affect, however, affect the status of the bonds.

In addition to arbitrage, the IRS has additional rules with respect to useful life and the “private Use” of bonds. These are also described in the Debt management Overview. This also requires continued private use. For instance, a building constructed using bond funds for a public use may not generally be resold for private use, although the “change is use’ provisions do provide for certain remedies. In addition, In addition, bonds may not exceed certain useful life criteria for the underlying capital assets.

As part of the due diligence process the nature of the bonds is reviewed to determine public/private use, including a review of the capital budget appropriation and purposes. This is completed by Bond Counsel and Finance & Management, with data from user departments as needed. Projects are also reviewed as to useful life. Cash flows of the project are reviewed prior to the development of the capital bill and before bond issuance to limit the potential for any arbitrage rebate and to verify that these are not arbitrage bonds.

On a monthly basis, the Director of Finance & Investments conducts a review for arbitrage earnings and compliance with spend down requirements. Also periodic reviews are conducted. A more formal review using the Post Issuance Compliance Checklist developed by the GFOA and the NABL will further document these efforts.

No instance of bond audit by the IRS has occurred on Vermont issued bonds.

# Office of the State Treasurer
# Internal Control Risk Map

| | |
|---|---|
| Risk Title: | Loss of Tax Exempt Status |
| Risk Description: | Violation of tax code applicable to bonds results in adverse impact, penaty or loss of tax exempt status. |
| Risk Category: | Statutory / Regulatory |

Strategic | Financial | Statutory / Regulatory | Operational | Human Capital | Technological

| | | | |
|---|---|---|---|
| Enter Impact Rating: | 5 | Enter Likelihood Rating: | 3 |
| Risk Rating: | 15 | Risk Level: | High |

| Impact | | | | | | |
|---|---|---|---|---|---|---|
| | 5 | Critical | | | 15 | |
| | 4 | Serious | | | | |
| | 3 | Moderate | | | | |
| | 2 | Minor | | | | |
| | 1 | Negligible | | | | |
| | | | Improbable | Possible | Probable | Near Certain |
| | | | 1 | 2 | 3 | 4 |
| | | | Likelihood | | | |

## Debt Management
## Arbitrage Rebate and Monitoring
Office of the State Treasurer

**Purpose:**
Arbitrage is an issue that relates to the tax-exempt status of the bonds (see above). In addition to willful creation of arbitrage bonds, there is provision within the IRS code where unforeseen actions create an arbitrage liability, i.e. excess earnings are earned on bond proceeds. If projects fall behind schedule or investment spreads are greater than anticipated, there may be an arbitrage "rebate' due to the IRS but not necessarily a determination that an arbitrage bond exists. There are certain requirements for tracking the arbitrage rebate. There are also established "safe harbors" within the IRS code.

**Risk Assessment:**

- Risk is assessed as high. While inadvertent generation arbitrage earnings outside the safe harbor rules has a limited financial impact (excess earnings are "rebated" to the federal government'), there are additional impacts if arbitrage rebate is not correctly monitored, calculated and remitted to the IRS. Failure to remit arbitrage rebates might be considered and intentional arbitrage act subject to penalty, interest and potential adverse impact on the status of the bonds. Likelihood, absent proper internal controls, is assessed as probable.

**Internal Control Objectives:**

- To assure compliance with all applicable IRS arbitrage statutes at the time of issuance, as affirmed by Bond Counsel

- To assure continued compliance during post issuance.

**Control Activities/Risk Mitigation**:

- At the time of the issuance of bond, Bond Counsel must give an opinion affirming the tax status of the bonds. Before rendering such an option, due diligence is conducted to assure compliance with various issues (see process below).

- Arbitrage calculations are completed monthly by the State Treasurer's Office.

- Cash flows on Projects are developed and monitored by the Department of Finance & Management

**Process:**

Arbitrage is the difference between the rate at which the proceeds were borrowed and the rate at which the proceeds were invested (California Asset Management program, p1). Section 148 is the principal IRS Code section governing arbitrage rebate, with additional provisions found in Section 103,149 & 150. IRS code requires arbitrage profits to be “rebated” to the federal government, although there are certain “safe harbors” or exemptions (see California Asset Management Program, p.3; Shannon, 2007, p. 8).

<u>Small Issuer Exception</u>:
This exception applies to municipalities with general taxing powers that issue $5 million or less, $15 million for public school facilities) of tax-exempt debt during a calendar year. Certain additional requirements apply in the case of refunding bonds. This exception only applied to governmental bond, not private activity bonds).

<u>Expenditure (Spend Down) Exemptions</u>
Interest earnings on proceeds are generally exempt from rebate if they are expended within two years. There are limitations on this related to refunding bonds. Specific spend down provisions in the IRS code include:

- Six Month Exception: Gross proceeds are spent within six months
- Eighteen Month Exception: Gross proceeds spent as follows:
    - 15% within six months
    - 60% within twelve months
    - 100% within eighteen months
- Twenty-Four Months Exception This exception applies to issues when at least 75% of the “available construction proceeds” are to be used for construction expenditures and are spent as follows:
    - 10% within six months
    - 45% within twelve months
    - 75% within eighteen months
    - 100% within two years

Gross proceeds includes interest earned and interest expected to be earned. Expenditures include interest withdrawn and expected to be withdrawn within six months for governmental purposes. The Federal Tax Reform Act of 1986 as incorporated in the U.S. Treasury Internal Revenue Code (IRC) sections 103 and 141 through 150 are the primary sections applicable to tax-exempt bonds. While there are many criteria the most common issues relate to private use, arbitrage, and useful life. Section 103 of the Code indicates that an “arbitrage bond” under Section 148 will not be tax-exempt. “The basic arbitrage rule is that a municipality may not invest the proceeds of a tax-exempt note or bond in such a manner so that the yield on the invested funds exceeds the interest rate being paid on its borrowing by more than .125%. If this rule is violated and the municipality does not qualify for an exception to this rule, its borrowing will be an “arbitrage bond” and consequently will not be tax-exempt under Section 103 of the Code. As such, the issuer will not be able to take advantage of the below-market interest rates that are typically available to municipal borrowers” (VLCT, 2005). There are "spend down" exemptions to this rule. Also, intent factors into the determination of “arbitrage”. If projects fall behind schedule, there may be an arbitrage “rebate’ to the IRS but not necessarily a determination that an arbitrage bond exists. There are certain requirements for tracking the arbitrage rebate. Intentional arbitrage would affect, however, affect the status of the bonds. In addition to arbitrage, another requirement is that the bonds issued must be for a public, not private use, generally bridges, schools, infrastructure used by the general public. There are however private uses that have a public benefit- pollution related clean-up, affordable housing, etc.  Private use and private debt service of the bond cannot exceed10% of the issue (5% on certain loans). Another issue is continued private use. For instance, a building constructed using bond funds for a public use may not generally be resold for private use, although the “change is use’ provisions do provide for certain remedies. In addition, In addition, bonds may not exceed certain useful life criteria for the underlying capital assets.

As part of the due diligence process the nature of the bonds is reviewed to determine public/private use, including a review of the capital budget appropriation and purposes. This is completed by Bond Counsel and Finance & Management, with data from user departments as needed. Projects are also reviewed as to useful life. Cash flows of the project are reviewed prior to the development of the capital bill and before bond issuance to limit the potential for any arbitrage rebate and to verify that these are not arbitrage bonds.

On a monthly basis, the Director of Finance & Investments conducts a review for arbitrage earnings and compliance with spend down requirements. Also periodic reviews are conducted. A more formal review using the Post Issuance Compliance Checklist adopted by the GFOA and the NABL will further document these efforts.

No instance of bond audit by the IRS has occurred on Vermont issued bonds.

## Office of the State Treasurer
## Internal Control Risk Map

Risk Title: Arbitrage Rebate

Risk Description: If projects fall behind schedule or investment spreads are greater than anticipated, there may be an arbitrage "rebate' due to the IRS

Risk Category: Statutory / Regulatory

Strategic | Financial | Statutory / Regulatory | Operational | Human Capital | Technological

Enter Impact Rating: 4 Enter Likelihood Rating: 3

Risk Rating: 12 Risk Level: High

| Impact | | | | | | |
|---|---|---|---|---|---|---|
| | 5 | Critical | | | | |
| | 4 | Serious | | | 12 | |
| | 3 | Moderate | | | | |
| | 2 | Minor | | | | |
| | 1 | Negligible | | | | |
| | | | Improbable | Possible | Probable | Near Certain |
| | | | 1 | 2 | 3 | 4 |
| | | | Likelihood | | | |

**Internal Control**

**Debt Management**

**Bond Issuance Costs**

Office of the State Treasurer

**Purpose:**

In addition to the interest on the amount borrowed, there are additional bond related expenses including, but not limited to:

- Bond Counsel Services,
- Printing of Bond Documentation,
- Credit Ratings Fees,
- Trustee/Paying Agent Services,
- Financial Advisor Consulting Fees, and
- Underwriter Compensation; and
- Verification agent (refunding issues)

The costs must be reasonable to the bond issue. The cost of issuing the debt will be expensed in the governmental fund and allocated to the projects approved for the corresponding fiscal year.

**Risk Assessment:**

- Risk assessment is deemed medium as the consequences of management of debt issuance costs include inaccurate allocation across capital projects, inaccurate or excessive payment.

**Internal Control Objectives:**

- To identify and include all costs in the appropriation for debt issuance and provide an accurate allocation of debt service costs.

- To verify that all bond issuance costs submitted for payment to the State of Vermont are valid and accurate.

- To accurately pay all invoices for payment in a timely manner.

**Control Activities/Risk Mitigation**:

- Use of a competitive RFP process for selection of major business partners including bond counsel, financial adviser, and underwriter (in a negotiated deal) and explicit identification of costs in contract documents.

- Application of accepted bond industry standard for expense items such as underwriter takedown.

- Internal review by supervisory staff in the Treasurer's office for reasonableness of expense budgets and comparison to contract terms.

- Segregation of budget preparation, posting of budget to VISION, and the accounts payable functions (Director of Finance and Investments, Department of Finance & Management, Treasury Operations).

- Appropriation controls in VISION.

**Process:**

- Annually the Director of Finance and Investments prepares an estimate of the issuance costs related to debt. These are reviewed by the Deputy Treasurer and are submitted to Finance & Management.

- Finance & Management determines, based on the approved capital budget for the fiscal year, the percentage that is to be applied to each capital project to obtain an amount equal to the projected issuance costs. Prior to this calculation, all “carry-forward” or excess funds from the prior year’s issuance appropriation are used to reduce the estimated current year need.

- Finance & Management “bills” each project, expense the capital appropriations and accumulate debt service issuance costs as a separate appropriation item/funding source.

- As invoices are received during the year, these are date stamped and forwarded to the Director of Finance and Investments, approved for payment, and sent to the Deputy Treasurer for review. Invoices are then processed through a separate division of the Treasurer’s office (Treasury Operations) per established accounts payable processes.

## Office of the State Treasurer
## Internal Control Risk Map

Risk Title: Excessive or Inappropriate Bond Issuance Costs

Risk Description: Bond issuance costs are excessive, inapproariate and/or do not receive propr accounting.

Risk Category: Operational

Strategic | Financial | Statutory / Regulatory | Operational | Human Capital | Technological

Enter Impact Rating: 2 Enter Likelihood Rating: 3

Risk Rating: 6 Risk Level: Medium

| | | | | | | |
|---|---|---|---|---|---|---|
| **Impact** | **5** | **Critical** | | | | |
| | **4** | **Serious** | | | | |
| | **3** | **Moderate** | | | | |
| | **2** | **Minor** | | | **6** | |
| | **1** | **Negligible** | | | | |
| | | | **Improbable** | **Possible** | **Probable** | **Near Certain** |
| | | | **1** | **2** | **3** | **4** |
| | | | **Likelihood** | | | |

**Debt Management**
**Selection of Bond Counsel, Financial Advisor and Underwriter**
Office of the State Treasurer

**Purpose:**
Bond Counsel, Financial Advisor and Underwriter are essential members of the bond issuance team. Their roles, as well as those of other business partners, are outlined in the Debt Management Overview document. Successful issuance and the avoidance of tax and pricing issues are predicated on the selection of qualified firms.

**Risk Assessment:**

- Risk is assessed as high. The qualifications of staff and firms selected are an underlying element in other risk areas including adverse determination, IRS sanctions, poor pricing for the State.

**Internal Control Objectives:**

- To acquire services of experts in this area with experience with bonds in structure and size of a least those of Vermont.

- To assure an open and fair competitive process.

- To obtain the best value, incorporating cost but within the context of achieving the optimum balance with the service needs and requirements.

**Control Activities/Risk Mitigation**:

- A competitive bond Request for Proposal (RFP) process is used to select the above parties. In the case of a negotiated bond sale, a competitive process to select underwriters is still completed (see overview document).

- RFP documents make the appropriate distinctions relative to the role of financial advisors and underwriters to avoid a conflict of interest.

- The RFP process is completed pursuant to the requirements of State Administrative Bulletin 3.5.

- RFP Selection process is conducted by more than one individual to assure that an open and competitive process exists.

- The RFP procedural process is completed by independent staff from the subject matter staff, providing a uniform and transparent process.

- Best practices in selection, as promulgated by the Government Finance Officers Association are used to guide the process.

- Criteria for consideration in the process include:
    - Experience
    - Certifications
    - Distribution & Capitalization
    - Strength
    - Qualification of Key Personnel
    - Familiarity with the State
    - References
    - Accessibility

**Process:**

All RFPs processes are conducted by the Contracts Coordinator, implementing a set of procedures consistent with Administrative Bulletin 3.5. Identification and notification of interested firms is completed and advertising is done in appropriate professional websites and journals.

An RFP Committee including the Treasurer, Deputy Treasurer, and the Director of Finance and Investments reviews the proposals. The independent Financial Advisor also participates (except obviously in the case of a RFP for that service), providing and independent expert advice. Generally, technical aspects of the respondent bid are considered first, so that “low cost’ is not the predominant consideration but rather a “best value’ considering the ability to provide the services, experience and the other factors listed above. Services are bid at least every four years.

## Office of the State Treasurer
## Internal Control Risk Map

Risk Title: Selection of Bond Counsel, Financial Advisor and Underwiter

Risk Description: Selection of key business partners without appropriate experience and credentials undermines the bond analysis and due diligence process.

Risk Category: Operational

Strategic | Financial | Statutory / Regulatory | Operational | Human Capital | Technological

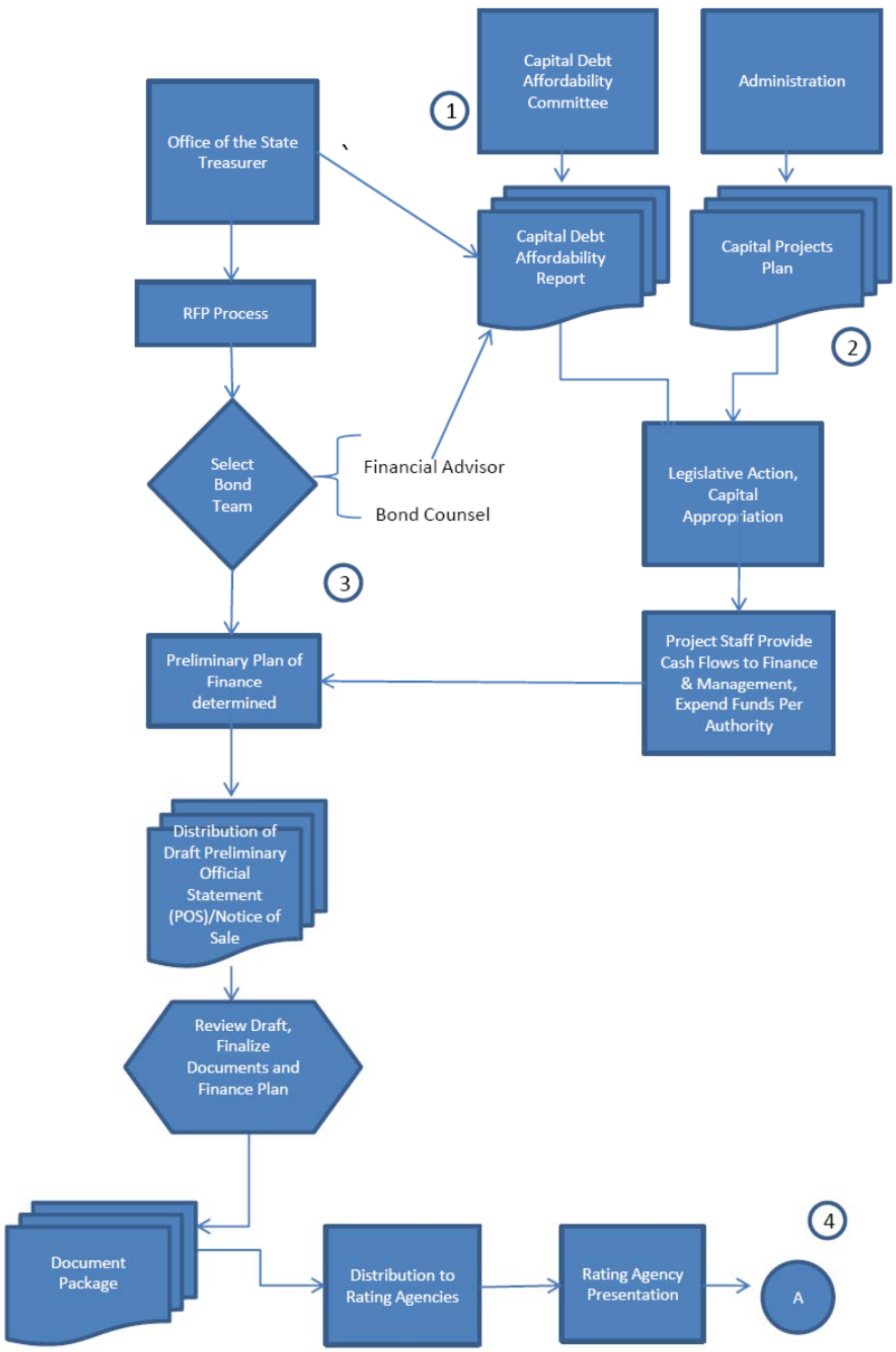
Enter Impact Rating: 4 Enter Likelihood Rating: 4

Risk Rating: 16 Risk Level: High

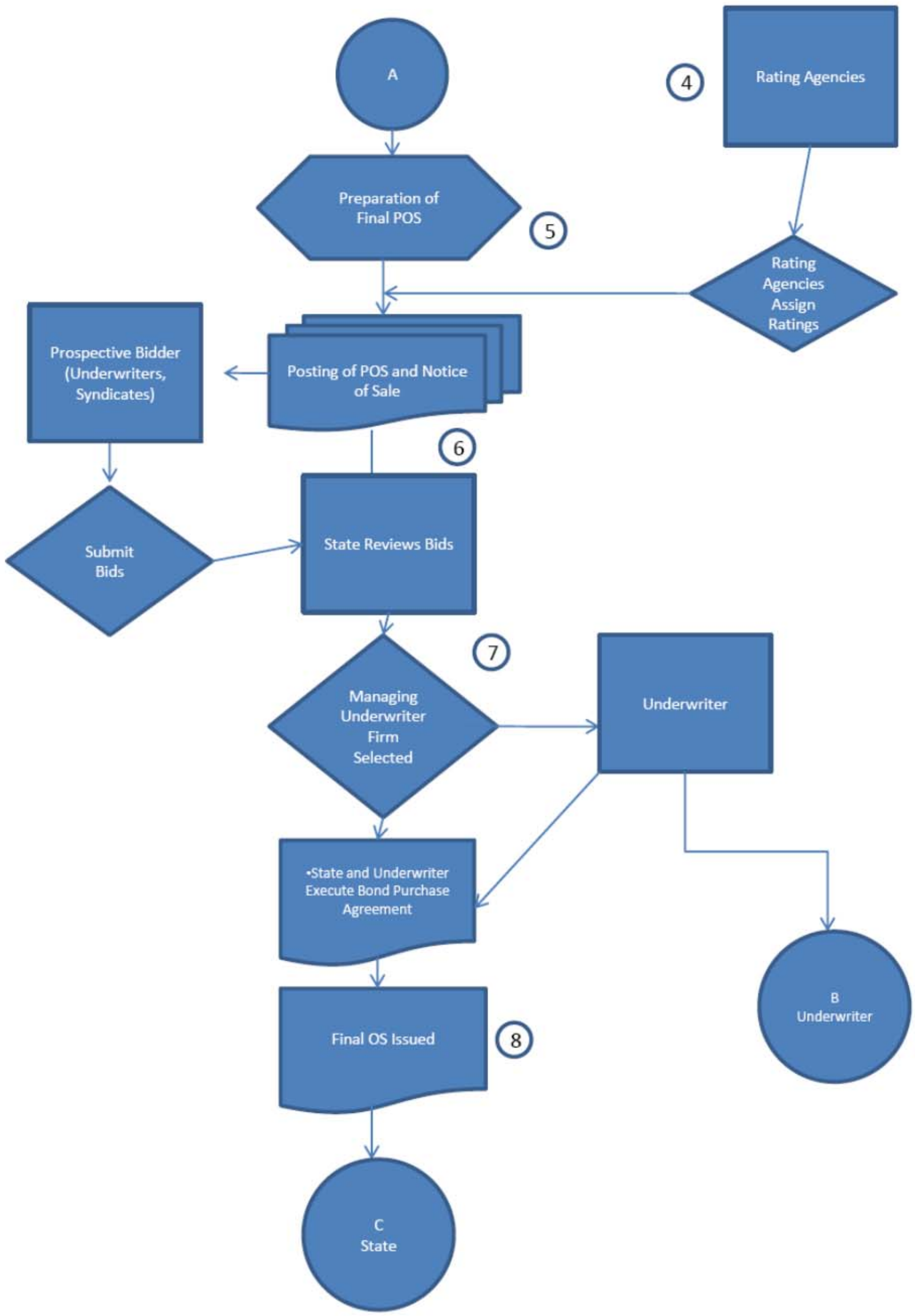
| Impact | | | | | | |
|---|---|---|---|---|---|---|
| | 5 | Critical | | | | |
| | 4 | Serious | | | | 16 |
| | 3 | Moderate | | | | |
| | 2 | Minor | | | | |
| | 1 | Negligible | | | | |
| | | | Improbable | Possible | Probable | Near Certain |
| | | | 1 | 2 | 3 | 4 |
| | | | Likelihood | | | |

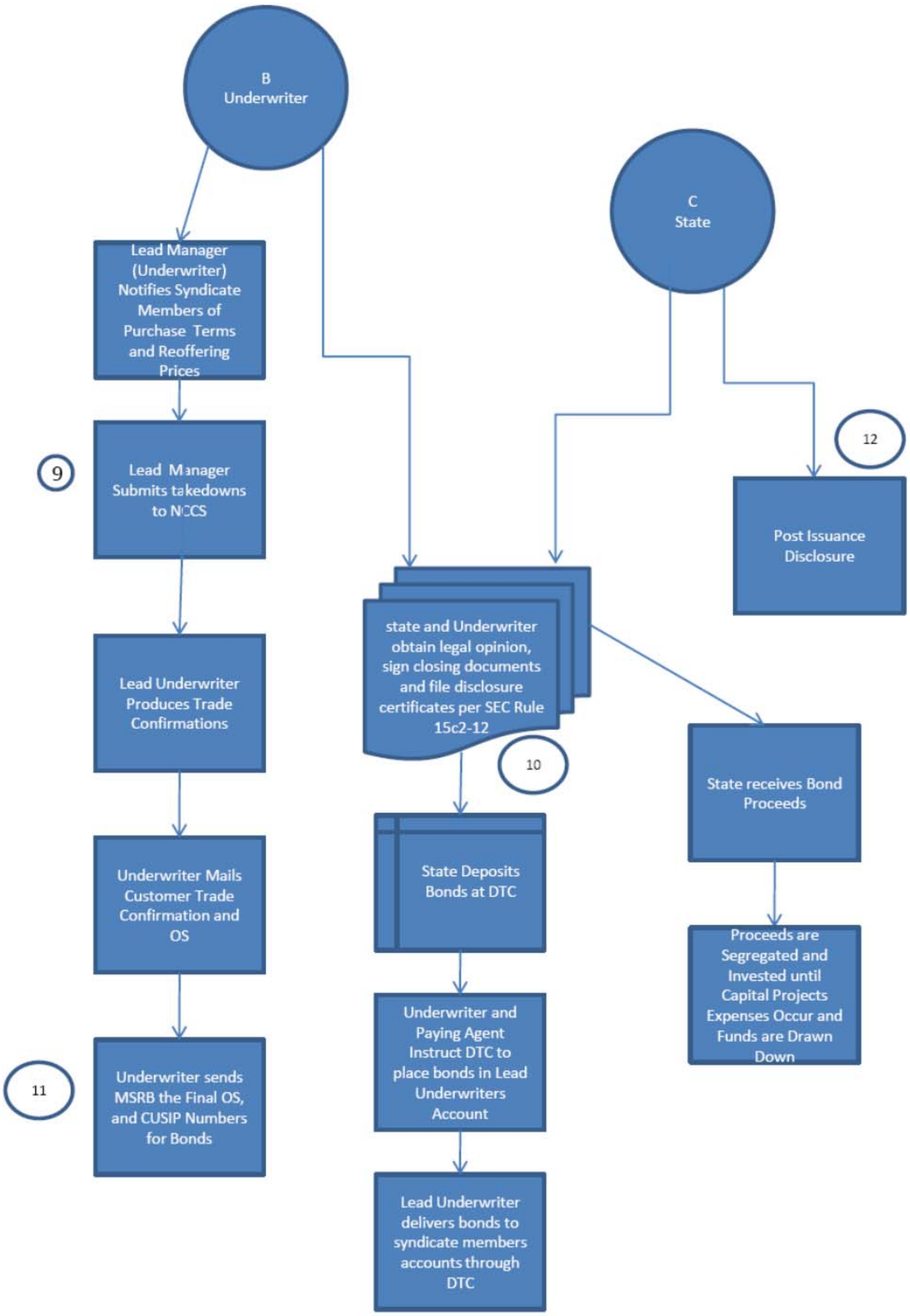
# Appendix 2A

## Bond Issuance Flow Chart[3]




[3] Sources: Bond market Association and Depository Trust and Clearing Corporation, 2003; Knorr, 2004; Oregon State Treasury, 1998; California Debt and Investment Advisory Commission, 2004, Vermont bond schedules.


A
4
Rating Agencies
Preparation of Final POS
5
Rating Agencies Assign Ratings
Prospective Bidder (Underwriters, Syndicates)
Posting of POS and Notice of Sale
6
Submit Bids
State Reviews Bids
7
Managing Underwriter Firm Selected
Underwriter
•State and Underwriter Execute Bond Purchase Agreement
Final OS Issued
8
B Underwriter
C State


B
Underwriter
C
State
Lead Manager (Underwriter) Notifies Syndicate Members of Purchase Terms and Reoffering Prices
9
Lead Manager Submits takedowns to NCCS
Lead Underwriter Produces Trade Confirmations
Underwriter Mails Customer Trade Confirmation and OS
11
Underwriter sends MSRB the Final OS, and CUSIP Numbers for Bonds
state and Underwriter obtain legal opinion, sign closing documents and file disclosure certificates per SEC Rule 15c2-12
10
State Deposits Bonds at DTC
Underwriter and Paying Agent Instruct DTC to place bonds in Lead Underwriters Account
Lead Underwriter delivers bonds to syndicate members accounts through DTC
12
Post Issuance Disclosure
State receives Bond Proceeds
Proceeds are Segregated and Invested until Capital Projects Expenses Occur and Funds are Drawn Down

# Notes to Debt Issuance Flow Chart- Appendix 2A

(1) The Debt Affordability Advisory Committee (CDAAC), chaired by the State Treasurer, completes an annual review of the size and affordability of the State tax-supported general obligation debt, and submits to the Governor and to the General Assembly an estimate of the maximum amount of new long-term general obligation debt that prudently may be authorized for the next fiscal year. The State's Financial Advisor provides consulting services for this task/report.

(2) The Governor will submit, in addition to the general operating budget a consolidated capital budget request for the following fiscal year. After consideration by the general Assembly, a Capital Bill is enacted.

(3) The major steps in the preliminary stages of the issuance process are:

   a. Select the financing team, including, financial advisor and bond counsel. Typically the State selects the Financial Advisor and Bound Counsel through RFP for a two to four year term, to work on all deals during that period.

   b. Determine the approximate size of the issue, taking into account amounts needed for costs of issuance, reserve accounts, and interest. Cash flows (expected use of bond proceeds) on existing and proposed projects are examined to properly size the issue. A plan of finance is developed, including size of the issue, call provisions, length of maturities, etc.

   c. Determine if competitive or negotiated sale

   d. If negotiated, underwriter is selected through RFP

   e. Verify the refinancing potential of existing debt, if possible and applicable

   f. Begin to draft the preliminary official statement (POS)
   g. Develop timetable for accomplishing remaining tasks (see Appendix 2B)
   h. Prepare legal Documents associated with sale (See Appendix 2B).

   In addition to outside consultants, the team will generally consist of Finance & Management, Budget and, Treasurer's Office staff. An economic consultant provides updated data and an economic outlook.

(4) The Treasurer, and key administration officials, generally the Governor, Secretary of Administration, Commissioner of Finance and Management), the Financial Advisor, and the economist, makes presentations to the rating agencies to obtain a bond rating. The bond credit rating measures the State's risk of paying all interest and principal back to investors. A standardized bond rating system is used to assess risk and assign a "grade" to

the bond. The three major rating agencies are Moody's Investor Services, Standard and Poor's, and Fitch Ratings. Ratings have a significant effect on both the ability of an issuer to raise funds and the price the issuer will be required to pay. Investors seek high quality issues, while lower quality issues are harder to place, at a much higher interest cost (source: California Debt and Investment Advisory Commission, Debt Issuance Primer Handbook, p7)

(5) The Preliminary Official Statement (OS) and subsequent final OS must disclose all material facts (i.e., facts that are important to an investor in making an informed investment decision) accurately and completely. In addition to the bond team identified above, other expert staff and department staff managing debt funded projects will play a role in verifying the accuracy of the information included in the OS.

(6) The flow chart is based on a competitive bid. See pages 20 and 21 of narrative for differences and the reasons for selection of a competitive or negotiated offering, including an overview of 'good faith" deposits.

(7) In a competitive offering, as outlined in the flow chart, the winning bidder is determined by applying rules specified in Notice of Sale. If winning bid is acceptable, the State award bonds to winning bidder and completes a Bond Purchase Agreement. The steps vary in a negotiated sale and are as follows::

a. Preliminary pricing discussion. Including review of comparable sales for rates and prices.
b. Timing of sale.
c. Identify supply of issues within timeframe of issue that may impact price.
d. Estimate market price movement.
e. Finalize proposed pricing scale.
f. Send out pricing wire to solicit orders.
g. Reprice as needed.
h. Agree upon the final rates and prices.
i. Execute Bond Purchase Agreement.

(8) Finalize and print Official Statement, describing final maturity schedule, interest rates, and reoffering prices to the public, as well as conforming descriptions of bonds and project to final design.

(9) The lead manager maintains the books and records for the syndicate account. Lead managers are required to submit the bonds allotted to syndicate members and other dealers on the initial trade date to the National Securities Clearing Corporation (NSCC), a wholly owned subsidiary of The Depository Trust & Clearing Corporation (DTCC), to

clear the trades and prepare for settlement. NSCC utilizes a “one-sided takedown” process. The lead manager submits all the syndicate members’ allotments on the initial trade date at the takedown price. Unless the participating dealers delete the trade as submitted by the manager, the trades will settle automatically. Municipal Securities Rulemaking Board (MSRB) Rule G-34requires the lead manager to notify NSCC of securities details and other information related to a new issue as soon as it is known. The eligibility staff of the Depository Trust Corporation (DTC), another subsidiary of DTCC, reviews new issue documentation. DTC requires submission of this documentation at least 10 business days before the closing date. MSRB Rule G-34 requires underwriters to apply for depository eligibility for a new issue of securities within one business day of either the award from the issuer or after the execution of the contract to purchase the securities from the issuer.

(10) At bond closing, which usually occurs two weeks following pricing, the final OS has been delivered to those investors who bought the bonds, and the underwriter wires the net proceeds to the issuer. Closing documents are reviewed executed (see Appendix 2B).

(11) Rule G-36 requires a lead manager/underwriter of new issue to submit copies of the final OS to the MSRB. If the issue advance refunds an outstanding issue, the rule also requires the underwriter to submit copies of the escrow deposit agreement to the MSRB. The lead manager also provides CUSIPS for the bonds and other documentation.

(12) The State has an obligation to maintain post issuance due diligence and disclosure including, but not limited to:

a. Monitor paying agent functions
b. Comply with ongoing covenants
c. Annual financial statements
d. Annual disclosure report filed with NRMSIRs
e. Monitor need for disclosure events pursuant to SEC Rule 15c2-12
f. Monitor arbitrage earnings and ensure arbitrage rebate compliance

The post-issuance checklist, developed by the GFOA and NABL (see narrative above) assists in identifying potential disclosure events.

## Appendix 2B_ Bond Document Preparation Schedules and Responsibilities

### Sample Financing Schedule Competitive Bond Issue

(See Abbreviation Key Below)

| Date | Activity | Responsible Party |
|---|---|---|
| Wed 10/12 | Distribution of Draft POS (BC)/Notice of Sale (FA) | BC/FA |
| Mon 10/17 | Conf. Call To Review Docs | All |
| Thurs 10/20 | Distribution of $2^{nd}$ Draft of Docs | BC/FA |
| Tues 10/25 | Conf. Call To Review Docs | All |
| Thurs10/27 | Distribution of Document Package to Rating Agencies | BC/FA |
| Mon 10/31 | Conf. Calls With Rating Agencies | VT/FA |
| Wed 11/2 | Distribution of Final Draft of Docs | BC/FA |
| Thurs 11/3 | Sign-off on Final Draft of Docs<br>Receipt of Bond Ratings | All<br>VT/FA |
| Fri 11/4 | Posting POS/Notice of Sale | BC/FA |
| Tues 11/15 | Sale on PARITY | All |
| Wed 11/23 | Closing/Transfer of Funds | All |

### Sample Financing Schedule Citizen Bond (Negotiated)

(See Abbreviation Key Below)

| Date | Activity | Responsible Party |
|---|---|---|
| Tues 11/22 | Distribution of Draft POS Wrapper | BC |
| Mon 11/28 | “Due Diligence” and POS Wrapper Review: | All |
| Tues 11/29 | Receipt of Ratings | FA |
| Wed 11/30 | Posting of POS | All |
| Mon 12/5 | Pre-pricing Call | VT,SM,FA |
| Tues 12/6 | Sale | VT,SM,FA |
| Tues 12/13 | Closing | All |

## Sample Official Statement Responsibilities

| Task: | Responsible Party |
|---|---|
| Cover Page | BC/FA |
| Elected Officers | TO |
| Underwriter Disclosure Bottom Half Page i | BC |
| Table of Contents | BC |
| Introductory Statement | BC |
| The Bonds | BC |
| Book-Entry Only System | BC |
| State Government | TO |
| State Economy | SE |
| State Funds and Revenues | FM |
| Recent Gen Fund, Transportation Fund and Education Fund Operating Results | FM |
| Revenue Estimates | FM |
| Major General Fund Programs and Services | FM |
| State Indebtedness | TO |
| Contingent Liabilities | AG |
| Reserve Fund Commitments | BB |
| Pension Plans | TO |
| Employee Relations | HR |
| Litigation | AG |
| Tax Matters | BC |
| Financial Advisor | FA |
| Ratings | FA |
| Legal Matters | BC |
| Certificates of State Officers | TO |
| Continuing Disclosure. Agreement | BC |
| Additional Information | TO |
| Appendix CAFR | FM |
| Appendix Form of Continuing Disclosure Agreement | BC |
| Exhibit – NRMSIRs | FA |
| Appendix – Form of Bond Counsel Opinion | BC |

### Key to Responsibility Abbreviations

| | |
|---|---|
| AG | Attorney General’s Office |
| BB | Bond Bank |
| BC | Bond Counsel – Edwards Angell Palmer & Dodge |
| FA | Financial Advisor – Government Finance Associates |
| FM | Finance and Management |
| HR | Department of Human Resources |
| SE | State Economist – Jeff Carr |
| TO | Treasurer’s Office |
| VT | Issuer- State of Vermont |
| SM | Senior Manager (Underwriter) |
| UC | Underwriter’s Counsel |

# Appendix 3
# Office of the State Treasurer
# Bond Issuance and Related Functions Procedures

**<u>Overview</u>**:
The office of the State Treasurer is, by statute, responsible for management of the State's short and long-term borrowing program including the issuance of bond, investment, calculation of arbitrage rebates, and the repayment of bond principal and interest.

**<u>Procedures:</u>**

**<u>General Obligation Bonds</u>**

1. A new account is set up at Fidelity to hold the par value of the bonds sold and invest the par value in government funds until the money is needed to pay expenses.
2. Once the bonds are sold, the proceeds are wired to the Banknorth Concentration account. The Treasurer's Office posts a general ledger journal entry to record the proceeds of the sale to the Proceeds of Bonds, Premium on Bonds, and Accrued Interest account. The cash account is the Banknorth Concentration account. This entry is broken out by Fund (GF, TF, and SF) based on the projects included in the bond issue.
3. Finance and Management puts the Premium on the Sale of Bonds into a Reserve for Debt Service at year-end. The Premium must be used against the first principal and interest payment for the new bond issue. Premium does not decrease the amount needed in the Debt Service Budget. However, it is used as a funding source.
4. Accrued interest stays on the books until the first interest payment is due. Accrued interest reduces the amount that is needed in the Debt Service Budget. The first payment on the new debt must include a reduction in the Accrued Interest liability.
5. The par value of the bonds sold (totaling the projects included in the sale) is wired to Fidelity to be placed in the new account.
6. Money is drawn to cover the expenses of the projects from this money on a periodic basis. Bond draws are covered later in a separate section.
7. Bond issuance costs are paid for these GO Bonds as the bills come in.

**<u>Citizens Bonds</u>**

1. A new account is set up at Fidelity to hold the par value of the bonds sold and invest the par value in government funds until the money is needed to pay expenses.
2. Once the bonds are sold, the proceeds are wired to the Banknorth Concentration account. The Treasurer's Office posts a general ledger journal entry to record the proceeds of the sale to the Proceeds of Bonds, Premium on Bonds, and Accrued Interest account. The cash account is the Banknorth Concentration account. This entry is broken out by Fund (GF, TF, and SF) based on the projects included in the bond issue.
3. When the bank confirms that the proceeds have been received, the Treasurer's Office wires the Underwriters fees directly to the Underwriter. This payment must be set up in VISION ahead of time so that the wire can go through the approval process and be ready

to be paid on the day of the sale of bonds. All other bond issuance costs are paid through the regular Vendor system as the bills come in.

4. Finance and Management puts the Premium on the Sale of Bonds into a Reserve for Debt Service at year-end. The Premium must be used against the first principal and interest payment for the new bond issue. Premium does not decrease the amount needed in the Debt Service Budget. However, it is used as a funding source.
5. Accrued interest stays on the books until the first interest payment is due. Accrued interest reduces the amount that is needed in the Debt Service Budget. The first payment on the new debt must include a reduction in the Accrued Interest liability.
6. The par value of the bonds sold (totaling the projects included in the sale) is wired to Fidelity to be placed in the new account.
7. Money is drawn to cover the expenses of the projects from this money on a periodic basis. Bond draws are covered later in a separate section.

## Refunding Bonds

1. All costs of issuing refunding bonds must be covered in the sale price (including Premium) of the bonds. The State does not budget for bond issuance costs on these bonds.
2. When Refunding Bonds are sold, all proceeds go into an escrow account (at this time the escrows are at Chittenden Trust).
3. The sale is recorded in revenues as refunding bonds issued. The cash is recorded in Chittenden Trust. The sale entry is split between Special Fund #21886 and the General Fund. The Special Fund receives the portion of the proceeds that covers the bond issuance costs.
4. The transfer to the escrow agent is posted to Payments to bond escrow agent and Chittenden Trust cash.
5. In order to pay the bond issuance costs, the Treasurer's Office files an excess receipts request with Finance and Management (through our budget analyst) to request the spending authority. This is done using the excess receipts in the Special Fund since no one is allowed to request excess receipts from the general fund.
6. The refunding bond issue is set up to be paid with its own debt service schedule. The money from the sale of the refunding bonds (that is now in escrow) is used to pay the refunded bonds when they come due.
7. The new payment schedule is then calculated for the remaining bond series that were not refunded in this bond issuance.
8. All savings on the issuance of refunding bonds are required to go to the general fund by statute. If any of the bonds that were refunded included Transportation or Special Fund projects, then the sum of the new payment on the refunded bond and the portion of the refunding bond attributed to the Transportation or Special Fund must equal the payment amount of the original bond debt service. In other words, there will be no change in the debt service for Transportation and Special Funds due to the issuance of refunding bonds.

## Budgeting For Debt Service

1. The Treasurer's Office is responsible for budgeting for the Debt Service of the bonds issued. This is done based on the individual debt service schedules provided by the

State’s financial advisor as each bond issuance occurs.  An estimated payment amount is included in the budget process for the current year’s bond issue based on what has been authorized for new debt by the Debt Affordability Committee and an estimated interest rate at the time the budget numbers are prepared.  Any necessary adjustment is made in the Budget Adjustment Act.

2. The budget must include the **gross** amount needed to pay the debt service less any accrued interest.  The premium received on a bond issue will have been put in a Reserve account by Finance and Management and may be used as a funding source.  Requesting the full amount in the budget gives the Treasurer’s Office the correct spending authority level needed to pay the debt service correctly.

**<u>Budgeting Bond Issuance Costs</u>**

1. Each year, the Director of Investments for the Treasurer’s Office estimates the amount needed to pay the Bond Issuance Costs.  This is done using last year’s numbers as a guide and factoring any new items expected for the budget year.  It is advisable to build in a small cushion.
2. Once the budget is approved, Finance and Management reduces the project funds based on their percentage of the total projects to give the Treasurer’s Office the necessary spending authority to pay the bond issuance costs.
3. As the bills come in for the bond issuances, the Treasurer’s Office charges them against the above mentioned spending authority and labels them as to which bond issue they apply to.

**<u>Payment of Debt Service</u>**

1. The Treasurer’s Office keeps an updated debt service spreadsheet compiled based on the debt service schedules provided by the State’s Financial Advisor.  This is broken out by fiscal year and the current fiscal years debt service payments.
2. The Treasurer’s Office receives invoices from Chittenden Trust approximately two weeks prior to the payment due date.  The Treasurer’s Office compares the invoices to their debt service schedules.  If there are any differences, the Chittenden Trust is contacted and the differences resolved.
3. Once the Treasurer’s Office and Chittenden Trust are in agreement, the voucher is entered into VISION for payment.  The money is sent by ACH with settlement on the due date of the payment.
4. The Treasurer’s Office verifies that Chittenden Trust received the money at 10 am on the due date.  If there is a problem, the Treasurer’s Office works to resolve it.

**<u>Bond Expense Drawdown</u>**

1. Project expenses are paid through the VISION vendor system.  Periodically, Finance and Management prepares a summary sheet of expenses paid for each project fund.
2. This summary is given to the Treasurer’s Office to draw down the Fidelity bond accounts to reimburse the State’s cash for the project expenses.
3. The Treasurer’s Office draws down the Fidelity bond funds utilizing Fidelity’s Slamnet website.

4. A journal entry is made in VISION to record this transfer from Fidelity bond cash to the Chittenden or Banknorth Concentration account.

**Fidelity Bond Interest Earned**

1. Each month, Fidelity posts the interest earned on the bond cash to the individual cash accounts at Fidelity.
2. The Treasurer's Office posts this interest to interest income in the Bond investment earnings fund.
3. This interest is drawn in quarterly from Fidelity to the Howard Concentration and a journal entry is posted in VISION.
4. At the end of each fiscal year, the interest earned on Bond funds is transferred to the General Fund. This is usually done once in late June to capture the eleven month period of July thru May and once in early July to capture June.

**Arbitrage Calculation**

1. The Federal Government (IRS) does not allow States to earn more interest on bond proceeds than they are paying in interest to borrow the money. If the State does earn more than they pay, the difference must be paid to the Federal Government (IRS). There are two primary exceptions to this.
    a. If the State spends the bond proceeds within two years and meets the spend down timeframes. The proceeds must be spent by these benchmarks: 10% by 6 months, 45% by 12 months, 75% by 18 months and 100% by 24 months.
    b. There is also an 18 month spend down version, but the State's drawdown patterns do not lend themselves to this option.
2. The Treasurer's Office monitors the Arbitrage benchmarks and discusses any issues with Finance & Management when necessary.
3. In order to meet spend-down requirements, it sometimes becomes necessary to "swap" projects associated with one bond issue to another. This is because sometimes the original projects are delayed with respect to completion or payment drawdown. In this instance, if projects from another bond issue not experiencing a problem in meeting spend-down targets have been completed and have payment due, these completed projects can be swapped to the issue requiring spend down. Following swap, the project payments are made and the spend-down target is achieved.
4. If the State does not earn more interest than the bonds cost (the arbitrage rate of return), there are no interest arbitrage earnings payments due to the IRS.

**Attachments:**
Note: Additional procedural guidance and a summary of State Statutes applicable to debt are found in the Procedures Manual.