Model Finance Transaction Policies for Public Entities:
Debt Management Policy

The State Funding Board is developing finance transaction policies to guide public entities in preparing their own policies. Adopting financial policies can help entities:

- make better financial decisions;
- provide clear objectives for staff;
- demonstrate strong financial management practices to credit rating agencies; and
- distinguish policy decisions from transaction decisions.

Adopting financial policies does not prevent unforeseen or negative events from occurring, nor does it prevent bad decisions. When public entities, including the State, all state agencies, local governments, and any other board, authority, district, or body created by any of these, are guided by sound financial policy in the financial decision-making process, the effects of negative events and bad decisions can be minimized.

All public entities incurring or issuing debt should have adopted a debt management policy by January 1, 2012. The minimum requirements for the policy are described below and required language is provided in Attachment A. The policy adopted by a public entity should address financing needs and the role debt will play in the overall financial management strategy. The policy need only address the particular types of debt that the entity plans to use. An entity may need only a simple policy, particularly if it borrows only through a federal or state agency loan program or from a community financial institution. A conduit entity, such as an industrial development board, lending only to private entities may need only a simple policy.

Before adopting a policy, the members of the public entity should have a basic understanding of public finance. This will allow the members to participate more fully in policy discussions and to gain more value from outside professional assistance. The entity bears sole responsibility for the development, adoption, and implementation of the policy, even when using professional assistance.

The scope of the debt management policy

The following four principles should be included in a debt management policy, whether simple or detailed, to guide every debt transaction:

- understand the transaction;
- explain to citizens what is being considered;
- avoid conflicts of interest; and
- disclose costs and risks.

The policy should address the following items in reasonable detail and should include methods by which the public and all stakeholders are informed about them:

- any decision to finance debt, how debt instruments will be structured and sold, and all proposed and actual costs involved in issuing debt;
- any extra costs related to issuing debt—for example, the costs of work performed by professionals;
- the selection process for professionals who provide services related to debt;
- any conflicts of interest;
- all ongoing debt and related costs;
- all initial and ongoing federal compliance issues; and
- the plan for regularly reviewing and amending the policy.

Minimum requirements of the policy

The debt policy must include provisions that cover transparency, professionals, and conflicts of interest written substantially to conform with the language in Attachment A.

For all public entities other than conduit entities lending to non-public entities, the policy must require clear disclosure of the terms and life of each debt issue, including principal and interest payments. This disclosure must include a debt service schedule outlining the rate of retirement for the principal amount. If the policy permits deferral of payment on principal or backloading, the policy must require specific justification for each deferral—it may not, however, permit blanket approval. In no event may payment of either principal or interest exceed the useful life of any asset financed.

It is recommended that the policy address the maximum total level of debt that the public entity is willing to assume. This may be based on locally adopted economic indicators, such as per capita debt, a comparison of debt to property values, or debt service as a percentage of revenues or expenditures. The policy should either require or recommend that this limitation be evaluated before additional debt is assumed and be monitored and reported to the governing body periodically.

Variable rate debt can be a valuable borrowing tool. It can provide flexibility and reduce the overall cost of debt. Variable rate debt does expose the public entity to additional risk. It is recommended that the policy address the level and type of variable rate debt the entity is willing to assume at any time.

A list of resources and a glossary are provided to assist with developing debt management policies. (See Attachments B and C.)