

Chicago Public Schools Policy Manual

Title: DEBT MANAGEMENT POLICY

Section: 404.1

Board Report: 08-0827-PO5

Date Adopted: August 27, 2008

Policy:

THE CHIEF EXECUTIVE OFFICER RECOMMENDS:

That the Board rescind Board Report 05-0427-PO1 "Debt Management Policy" and adopt a new Chicago Public Schools Debt Management Policy.

POLICY TEXT:

I. Purpose and Goals

The purpose of this policy is to enhance the Board's ability to manage its debt in a fiscally conservative and prudent manner. The effects of decisions regarding types of issue, method of sale, and payment structure directly impact the Board's finances. To ensure the Board's continued access to the capital markets, the Board has established a "Debt Management Policy" to provide goals and guidelines for the Board's debt issuance activity and use of tax-exempt financed proceeds.

In following this policy, the Board shall pursue the following goals:

- The Board will endeavor to attain the best possible credit rating in order to reduce interest costs.
- The Board will take all practical precautions and proactive measures to avoid financial decisions that can negatively impact credit ratings.
- The Board will determine the amortization (maturity) schedule that will best fit within the overall existing debt structure at the time the new debt is issued.
- When issuing debt, the Board will determine the mix of variable and fixed rate debt that best manages its overall interest costs, while considering risks and benefits associated with each type of debt.
- The Board will explore, assess risk, and implement innovative structuring ideas including the use of derivative instruments when they are consistent with the above goals.
- The Board will remain mindful of debt burdens in relation to equalized assessed value growth within the school district, overlapping debt of other local governments, the tax burden associated with long-term capital requirements, and other debt burden measures as appropriate.
- The Board will be cognizant of market conditions when issuing debt.

II. Authorization and Use of Debt and Derivative Instruments

The Board may issue debt or enter into derivative contracts as authorized by the laws of the State of Illinois, which may be amended from time to time. Unlimited tax debt to the extent authorized for the Board, exclusive of alternate revenue bonds, requires referendum approval.

State of Illinois law currently authorizes the Board to incur debt, borrow money, issue bonds for public improvement projects and for short-term cash requirements, enter into lease obligations, and enter into derivative contracts.

A. Use of Debt Issues

Under the provisions of the law, the Board may issue debt to pay for the cost of acquiring, constructing, reconstructing, improving, extending, enlarging, and equipping its capital stock, to refund existing debt, or to meet its cash flow needs.

The Board should not finance general operating costs from debt having maturities greater than one year. General operating costs include, but may not be limited to, those items normally funded in the Board's annual operating budget and having a useful life of less than one year. However, the Board may deem it necessary to finance cash flow requirements under certain conditions. To the extent a borrowing finances a revolving fund such as a working cash fund that may be used to finance several years of operating costs, a longer maturity schedule may be appropriate.

- **Short-Term Debt:** Debt with maturities less than one year from the date of issuance. The Board may issue short-term debt when such instruments allow the Board to meet its cash-flow requirements or provide increased flexibility in its financing program. Short-term debt may include, but is not limited to, tax anticipation warrants, lines of credit, working cash bonds, commercial paper and general obligation notes or other financing instruments authorized by the State of Illinois.
- **Long-Term Debt:** Debt with maturities of greater than one year from the date of issuance. The Board may issue long-term debt when the duration of the debt issue is consistent with the economic or useful life of the improvement or asset that the issue is financing. Long-term debt may include, but is not limited to, alternate revenue bonds, certificates of participation, limited tax bonds and capital tax bonds or other financing instruments authorized by the State of Illinois. The Board may also enter into long-term leases for public facilities, property, and equipment.
- **Fixed Rate Debt:** Debt that pays interest based on a fixed coupon rate until maturity. The Board may issue fixed rate debt when it is determined to be prudent based upon the Board's existing mix of variable and fixed rate debt as evaluated against benchmarks which may be published by or obtained from nationally recognized credit rating agencies, the Government Finance Officer's Association, or other similar sources, market rates at the time of issuance, and the Board's overall interest cost and risk profile.
- **Variable Rate Debt:** Debt that pays interest based on a rate which is reset periodically. The Board may issue variable rate debt when it is determined to be prudent based on the Board's existing mix of variable and fixed rate debt as evaluated against benchmarks which may be published by or obtained from nationally recognized credit rating agencies, the Government Finance Officer's Association, or other similar sources, the risks associated with variable rate debt, market rates at the time of issuance, and the Board's overall interest cost and risk profile.

B. Use of Derivative Instruments

Derivative products are financial instruments created from or whose value depends upon (is derived from) the value of one or more underlying assets or indices of asset values. Derivatives include instruments or features such as interest rate swaps, options, cap/floors/collars, rate locks, forwards, and futures. Derivative contracts may be entered into in conjunction with any currently outstanding or proposed bond issue. When considering derivative transactions the Board will require supporting legal opinions or other evidence of state law and/or Federal tax law compliance.

Derivative transactions may only be used for appropriate purposes that provide a measurable benefit to the Board such as:

- Significant interest cost savings that would otherwise not be available from accessing the traditional fixed rate municipal bond market.
- Reducing the Board's overall exposure to risk in the context of a particular financing.
- Hedging risk in the context of the overall management of the Board's asset/liability profile and fixed /variable rate debt mix.
- Such other appropriate purpose as is identified by the Board.

The Board shall not enter into derivative transactions for speculative purposes.

C. Use of tax-exempt bond proceeds:

In order for bonds issued by CPS to maintain tax-exempt status, several requirements must be satisfied from and after the date of issuance of the bonds. Among other things, these include requirements related to the use of proceeds of the bonds. The use of tax-exempt financed proceeds is governed by the Internal Revenue Code of 1986, as amended (the "Code").

The bonds are issued to (i) pay costs of constructing, acquiring and equipping school and administrative buildings, site improvements and other real and personal property in and for the School District and (ii) pay costs related to the issuance of the Bonds, including bond insurance premium.

Qualified purposes includes the cost of acquisition of all land, rights of way, property, rights, easements and interests, acquired by the Board for such construction, the cost of demolishing or removing any buildings or structures on land so acquired, including the cost of acquiring any lands to which such buildings or structures may be moved, the cost of all machinery and equipment determined to be necessary and desirable by the Board, the costs of issuance of the Bonds, financing charges, financial advisory fees, consultant fees, interest prior to and during construction and for such period after completion of construction as the Board shall determine, the cost of engineering and legal expenses, plans, specifications, estimates of cost and revenues, other expenses necessary or incident to determining the feasibility or practicability of constructing any portion of the Project, administrative expenses and such other costs, expenses and funding as may be necessary or incident to the construction of the Project, the financing of such construction and the placing of the Project in operation.

Per the Code, no less than 95% of the proceeds, and interest earnings thereon, raised by tax-exempt bonds issued by CPS must be used for qualified purposes including the construction, acquisition and equipping of school and administrative buildings, site improvements and other real and personal property in and for the School District, all in accordance with the estimate of cost, including the Board's Capital Improvement Program, as heretofore approved and from time to time amended by the Board.

D. Lease or Sale of Bond Financed Assets:

Amounts received from the sale of real estate including common school lands and any investments purchased with such proceeds (not including earnings derived therefrom) in the Board's treasury shall be deposited in a "Capital Assets Account." (See Board Policy 401.11 - Use of Proceeds From Sale of Real Estate and Rental Income from Lease of Real Estate dated February 27, 2002).

E. Charter School Capital and Facility Budget :

Charter Schools are separate legal entities, which are not state or local governmental units. Allocations of capital funds to any such separate legal entity shall be limited to improvements of, or repairs to Board Property, defined as any building or other real property owned or leased by the Board, including any real property held by the City of Chicago in trust for the Board or held by the Public Building Commission.

In preparing the annual fiscal year budget, the CFO shall determine whether and how much of the Board's capital funds should be expended to improve and repair Board Property that is or will be leased to Charter Schools (see Board Policy 410.9 – Charter School Capital and Facility Budget Policy). The CFO and the Chief Executive Officer (CEO) shall make recommendations to the Board regarding said capital support. As part of the annual budget process, any capital funds allocated to improve Board Property that is or will be leased to a Charter School shall be approved by the Board prior to any expenditures. Any Charter School lease shall not be for a period more than five years and shall not provide the lessee with any rights to renew. Further, all Charter School leases shall comply with any applicable federal or state laws regarding tax-exempt financing.

III. Debt Issuance Methodology

A. Establishing Financing Priorities

The Board faces continuing capital infrastructure and cash requirements, the costs of which will be met, in large part, through the issuance of various types of debt instruments.

The Chief Financial Officer will administer and coordinate the Board's debt issuance program and activities, including timing of issuance, method of sale, type and structure of issue, marketing strategies, use of derivative instruments, and selection of external financial professionals. The Chief Financial Officer will meet with senior Board officers, Board staff and Board members, as appropriate, regarding the status of the current year's program and to make specific recommendations.

B. Review of Financing Proposals

All capital financing proposals involving a pledge of the Board's credit through the sale of securities, execution of loans or lease agreements, entering into derivative contracts or otherwise directly or indirectly lending or pledging the Board's credit shall be referred to the Chief Financial Officer who shall determine the financial feasibility of such proposals and make recommendations accordingly to the Board.

C. Determining Financing Plan

The following factors will be considered when determining the type and maturity structure of debt issuances, as well as any associated derivative contracts.

1. Debt issued to finance capital improvements will be integrated with the Board's long-term capital plans. Consideration will be given to matching the length of the issue with the asset lives whenever practicable, while considering repair and replacement costs of those assets to be incurred in future years as an offset to the useful lives, and the related length of time in the payout structure.
2. The Board will consider the continuing impact of debt and derivative contracts upon the annual operating budget. Amortization schedules and debt service requirements will be integrated with revenues identified as available for debt service, and when such revenues are pledged as security for alternate revenue bonds, they will equal or exceed alternate bond coverage requirements as determined by state law.
3. Debt issuance risks and considerations:
 - a) **Credit Risk.** The risk that the Board may not be able to meet its debt obligations in the future.
 - b) **Tax Risk.** The Board should consider risks associated with changes in tax laws or events relating to the tax-exempt status of the Board's obligations, which could result in increased future debt service costs to the Board.
 - c) **Statutory Debt Limitation.** The School Code of the State of Illinois currently limits the Board to total outstanding debt equal to 13.8% of the school district's equalized assessed value. Alternate bonds and tax anticipation warrants generally do not count against this limit.
 - d) **Debt Burden Measures.** The Board will consider the impact of the issuance of additional debt on the following measures as evaluated against debt burden benchmarks which may be published by or obtained from nationally recognized credit rating agencies, the Government Finance Officer's Association, or other similar sources:

- *Ratio of Net Bonded Debt to Estimated Full Value.* The formula for this computation is Net Bonded Debt, which is the total outstanding debt, divided by the current Estimated Full Value.
 - *Net Bonded Debt Per Capita.* The formula for this computation is Net Bonded Debt divided by the population of the City of Chicago, based upon the most recent estimates as determined by the United States Bureau of the Census.
 - *Ratio of Annual Debt Service to General Funds Expenditures.* The formula for this computation is annual debt service expenditures divided by General Funds (i.e., General, Special, and Debt Service Funds) expenditures (excluding certain interfund transfers).
- e) **Overlapping Debt.** The Board will consider the impact of the issuance of additional debt on the total outstanding debt and financing plans of local governments that share the same tax base as the Board.
- f) **Capital Markets.** The Board shall consider products and conditions in both regional, local, domestic and international capital markets in meeting the Board's financing needs and timing its debt issuances and derivative contracts.
- g) **Credit Ratings.** The Board shall consider the impact of additional debt and/or its financing plans on credit ratings.
- h) **Credit Enhancements.** The Board may enter into credit enhancement agreements with commercial banks, insurance companies, or other financial entities, in order to lower borrowing costs or reduce restrictive covenants.
4. Risks and considerations associated with Fixed Rate Debt:
- a) **Risk/Benefit Analysis.** The impact of fixed rate debt on the Board's future debt service and budgetary obligations must be considered. Benefits of fixed interest costs shall be analyzed against alternative structures which may offer potential cost savings along with additional risks.
- b) **Interest Rate Risk.** The risk that future interest rate changes will affect the Board's interest costs. While fixed rate debt eliminates future increased costs due to interest rate changes, if such fixed rate debt is unable to be refunded in a lower interest rate environment, the Board's interest cost will be locked in at a higher fixed rate.
- c) **Call Features.** The price of call features and the impact on the Board's future ability to manage interest rate costs should be considered when issuing fixed rate debt.
- d) **Yield Curve.** The current yield curve should be considered when issuing fixed rate debt.
- e) **Amortization.** The maturity schedule and repayment amounts shall be structured to best take advantage of current market conditions and maximize future credit availability.
5. Risks and considerations associated with Variable Rate Debt:
- a) **Risk/Benefit Analysis.** The impact of variable rate debt on the Board's future debt service and budgetary obligations must be quantified and either mitigating factors identified or increased financial benefits such as interest cost savings or increased proceeds established to compensate for the risks identified below. Modeling different stress case scenarios may quantify this impact. The transaction analysis should provide assumptions for potential increased costs associated with the risks identified below. Potential costs could be mitigated by

the establishment of a reserve or by entering into a derivative contract to hedge interest rate risk.

- b) **Interest Rate Risk.** The risk that interest rates will increase to a level resulting in debt service greater than what has been budgeted.
- c) **Tax Risk.** The risk that changes in tax laws or events relating to the tax-exempt status of the variable rate bond issue will occur prior to the final maturity and could result in increased interest rates.
- d) **Liquidity Renewal Risk.** Variable rate demand notes require liquidity in the event that a remarketing agent is unable to remarket the bonds. A liquidity facility is a contract between the Board and a bank, insurance company or other financial entity as Liquidity Facility Provider, to temporarily act as owner of the bonds in the event that holders of the bonds tender the bonds back to the Board and the bonds cannot be immediately remarketed. Liquidity providers usually commit to terms from three to five years. Future liquidity renewal costs may fluctuate with supply and demand of the market and thereby affect the overall cost of variable rate debt.
- e) **Remarketing Risk.** The market for the short-term tax-exempt bonds may change in the future. To the extent that the remarketing agent cannot find buyers, the Board will pay a higher interest rate on the loan pursuant to the liquidity agreement.
- f) **Auction Risk.** The risk that variable auction rate debt results in a failed auction, whereby bondholders or potential bondholders are unwilling to receive rates lower than the maximum rate set by the auction, in which case the Board will pay the higher maximum auction rate.
- g) **Credit Risk.** Changes to the Board's credit rating affect its cost of borrowing. Adverse future credit changes will impact the interest rate, auction, liquidity renewal and remarketing risks described above.

6. Risks and considerations associated with the use of Derivative Instruments:

- a) **Risk/Benefit Analysis.** The impact of a derivative instrument on the Board's future debt service and budgetary obligations must be quantified. Either mitigating factors shall be identified, or increased financial benefits established, such as interest cost savings or increased proceeds, to compensate for the various associated risks. Modeling different stress case scenarios may quantify this impact. Potential costs could be mitigated by the establishment of a reserve or offset by expected savings. Derivative structures should provide as much flexibility as possible to the Board without substantially reducing the benefits of the transaction. The potential cost of terminating the transaction should also be evaluated.
- b) **Basis Risk.** The risk of increased cost when interest rates paid and/or received pursuant to a derivative contract or its hedge are derived from two related but not identical markets that match imperfectly.
- c) **Counterparty Risk.** The success of the derivative transaction depends on the other party fulfilling its obligations. To the extent that the counterparty does not meet its obligations, the Board could be exposed to additional costs in the future. This risk may be mitigated by collateral requirements, Triple –A rated counterparties, strong downgrade provisions, and rights to assign the agreement. The Board should diversify its exposure to counterparties.
- d) **Interest Rate Risk.** Interest rate movements over time could adversely affect the market value of derivative instruments. The market valuation at any point in time will identify whether a termination event would result in a payment by or to the Board. The Board shall monitor derivative transaction market values, and

disclose them as provided for according to generally accepted accounting principles.

- e) **Termination Risk.** The Board may incur future potential costs in the event the transaction is terminated. Most derivative structures provide for two-way termination payments. The risk that a termination event will occur must be considered, along with the magnitude of the potential cost to the Board associated with such an event.
- f) **Rollover and/or Amortization Risk.** The risk occurs when the term and amortization of the derivative contract does not match the term and amortization of the associated bonds. When the Board enters into derivative contracts for the purpose of hedging variable interest rates associated with underlying bonds, the term and amortization of derivative contract should match that of the bonds.
- g) **Credit Risk.** Adverse future credit changes will impact the basis, termination, and rollover risks described above. The use of derivative instruments may also impact the Board's credit rating. Treatment of the transaction by rating agencies should be researched prior to entering into a derivative transaction. The Board should not enter into a transaction which will negatively impact its credit rating.
- h) **Future Flexibility.** The long-term implications associated with any derivative transaction should be analyzed with regard to the Board's traditional costs of borrowing, historical interest rate trends, variable rate capacity, credit enhancement or liquidity capacity, opportunities to refund related debt obligations, impact of accounting for the transaction on the Board's financials and other similar considerations.

D. Method of Sale

Both negotiated and competitive methods of sale shall be considered for all debt issuances and derivative contracts. The sale parameters for any derivative bid process should be disclosed in writing to all potential bidders prior to the bid.

E. Refunding

The Board shall consider refunding or restructuring outstanding debt when financially advantageous and/or beneficial for structuring purposes.

Refunding for financial benefit should consider establishing net present value savings targets for each outstanding bond maturity, likelihood of future additional savings, and gross savings as a percentage of cost of issuance. Refunding for restructuring purposes may or may not consider these or other factors, however the costs and benefits of the transaction shall always be evaluated.

Structures which increase savings through alternatives such as derivative contracts, non-standard call provisions, and investments other than Treasury Securities shall be evaluated by identifying additional risks, quantifying potential costs, and either identifying mitigating factors or increasing established savings targets to compensate the Board for taking additional risk.

F. Financial Advisors

The Board should employ Financial Advisors when practicable to assist in managing the Board's debt portfolio, evaluating and executing transactions, monitoring and verifying fair pricing, and generally representing and acting in the Board's best interests.

G. Investment of Borrowed Proceeds

The Board has an on-going fiduciary responsibility to actively manage the proceeds of debt issued for public purposes in a manner that is consistent with Illinois statutes governing the investment of public funds, and with the covenants of related bond documents executed by the

Board. The Board's investment policy shall govern specific methods for investing bond related proceeds. The management of public funds shall enable the Board to respond to changes in markets or changes in payment or construction schedules so as to maintain principal, maximize yield, ensure liquidity and minimize risk.

H. Debt Service Reserves

The Board may elect to use its operating funds to establish a reserve balance accounted for within the Debt Service funds to be used for the following purposes:

1. To provide for costs resulting from certain risks associated with Variable Rate Debt and the use of Derivative Instruments as described above.
2. To provide for debt service expense in lieu of operating funds as determined to be necessary and/or desirable by the Board.
3. Any other governmental purpose approved by the Board.

When such reserve balance is established, the Board shall annually review and determine the amount required to provide for purposes 1 and 2 described above. The CFO shall authorize any transfers to or from such reserve balance.

IV. Compliance and Administration

A. Accounting and Reporting of Debt and Derivative Transactions

1. Generally Accepted Accounting Principles. The Board must account for all debt and derivative transactions according to generally accepted accounting principles. Statements of indebtedness and information regarding the Board's debt and derivative transactions shall be reported annually in the Comprehensive Annual Financial Report ("CAFR").
2. Debt Reporting. The CAFR will provide debt disclosure including future debt service requirements, the amount of gross direct debt, deductions from gross debt, net debt, equalized assessed valuation and net debt expressed as a percentage of equalized valuation.
3. Derivative Instrument Reporting. The CAFR will provide detailed disclosure of the Board's derivative contracts including the purpose for the transaction, counterparty information, and an explanation of the risks associated with the transaction.

The Board shall also prepare a comprehensive quarterly report for each derivative transaction that lists the counterparty with their current ratings, the notional amount of the contract, the termination value, and tracks basis and other risks as identified above to the extent they affect the transaction, as well as collateral requirements.

B. Financial Disclosure

The Board shall prepare appropriate disclosures as required by the Securities and Exchange Commission, the federal government, the State of Illinois, rating agencies, underwriters, bond counsel, investors, taxpayers, and other appropriate entities and persons in order to ensure compliance with applicable laws and regulations. The CAFR shall include required disclosure information such that disclosure requirements may be met through filing the CAFR with the appropriate parties, to the extent practicable.

C. Federal Arbitrage Requirements

The Board shall comply with Federal arbitrage requirements, including making rebate and yield reduction payments when due and maintaining yield restrictions as applicable. The Board shall employ arbitrage calculation agent(s) to monitor potential liabilities and shall maintain or cause to be maintained an appropriate system of accounting to calculate bond investment arbitrage earnings in accordance with the Internal Revenue Code, as amended or supplemented, and related applicable United States Treasury regulations.

D. Rating Agency Relations

The Board shall maintain effective relations with the rating agencies. The Chief Financial Officer along with the Board's financial advisors shall communicate with the rating agencies on a consistent and regular basis so as to keep the agencies informed concerning the Board's capital plans, debt issuance program and other appropriate financial information.

E. Investment Community Relations

The Board shall maintain a positive relationship with the investment community. The Chief Financial Officer shall, as necessary, prepare reports and other forms of communication regarding the Board's indebtedness, as well as its future financing plans. Such information should be presented to the media and other public sources of information.

F. Debt Policy Review

The Board shall periodically review and update this policy as may be necessary to assure that it meets all regulatory and disclosure requirements as well as attaining the fundamental goal of reducing both borrowing costs and all associated financing risks.

V. Effective Date

This Policy is effective immediately and applies to all debt and derivative instruments issued and/or entered into as of August 27, 2008.

Amends/Rescinds:	Rescinds 05-0427-PO1
Cross References:	96-1023-PO1
Legal References:	Internal Revenue Code of 1986, as amended; laws of the State of Illinois; and The School Code of the State of Illinois.