Comptroller of the Treasury

Quarterly Fiscal Affairs Report

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State law directs the Comptroller to make quarterly reports to the Fiscal Review Committee concerning the state's fiscal affairs. This report focuses on debt issuance in the State of Tennessee.

Tennessee Bond Financing

People have used credit systems to buy and sell goods for thousands of years. The ability to borrow money was as essential as fertile soil to the success of wheat, barley, and date farms in the cradle of our civilization. The use of debt as a means of financing continues today because it is recognized as one of the most equitable ways to pay for a project. In the same way that experienced foresters use controlled burning to allow forestland to renew itself, trusted financial professionals help us borrow money responsibly to finance the projects our constituents require for growth. Credit or debt, in many ways, is like fire—it is essential to renewal, but it must be managed responsibly.

The State of Tennessee borrows money primarily to finance capital projects, particularly projects that cannot be funded in a single year. This practice is common among states and local governments and is known as "issuing debt." Unlike other jurisdictions, though, the State of Tennessee does not issue debt to finance operating expenses or highway construction.

There are four state boards that supervise the somewhat complicated debt issuance process: the State Funding Board, the Tennessee State School Bond Authority, the Tennessee Housing Development Agency, and the Tennessee Local Development Authority.

- The State Funding Board issues short-term commercial paper and long-term general obligation bonds to finance public projects approved by the General Assembly. These are direct obligations of the State of Tennessee to which there is pledged the "full faith and credit" of the state. All such obligations constitute a lien upon the fees, taxes, and other revenues allocated to various state funds, including the general fund, the debt service fund, and the highway fund. As a practical matter, under Tennessee law and its constitution, timely payment of the state's general obligations has the highest priority. The term "state debt" usually refers to the state's general obligation debt. Accordingly, the primary focus of this fiscal report is the State Funding Board and the state's general obligation or "g.o." debt.

- The Tennessee State School Bond Authority (TSSBA) issues bonds to finance capital projects for public education in Tennessee. These are usually projects of the University of Tennessee system, including its branches and divisions, and the Tennessee Board of Regents of the State University and Community College System, but may also be projects of local governments or the Tennessee Student Assistance Corporation. The TSSBA does not have taxing authority and its obligations are not direct obligations of the state. They are usually secured by the revenues and fees received by the borrowing institution and are issued for projects like parking garages and dormitories that are projected to produce revenues sufficient to fund the debt service of the loan.
- The Tennessee Housing Development Agency (THDA) issues bonds to fund low- to moderate-income housing loan programs. THDA mortgage revenue bonds are generally special limited obligations payable solely from THDA revenues, which include homeowners' payments of principal and interest on THDA loans. Until 2013, THDA bonds carried the state's "moral obligation" pledge—an unenforceable understanding that the General Assembly would appropriate necessary funds to prevent a default in the payment of principal or interest on the THDA bonds. Starting in 2013, all new THDA bonds are issued with clear documentation that such bonds do not carry the state's moral obligation pledge. THDA is also reducing the amount of bonds subject to the state's moral obligation pledge by "refunding" outstanding bonds that carry the pledge with bonds that do not, as opportunities arise. Over $1 billion of "new" or "refunding" bonds (approximately 56 percent of THDA bonds outstanding as of November 20, 2014) do not carry the state's moral obligation pledge. The Bond Finance Committee exercises general oversight of THDA's financial operations, including debt issuance and debt management.
- The Tennessee Local Development Authority (TLDA) has broad authority to issue bonds and use the proceeds to fund loans to local governments for public works projects. TLDA's debt obligations are not obligations of the state. The TLDA works with the Tennessee Department of Environment and Conservation to make low interest rate loans to local governments across the state to fund wastewater and drinking water projects. The state receives federal grants and deposits a matching percentage of state appropriations into the clean water and drinking water state revolving funds to fund these loans. The TLDA does not issue any debt for these programs. Revenues from the water and wastewater systems are used to repay these loans.

Membership of State Debt Issuing Boards

State Funding Board	Tennessee State School Bond Authority	Tennessee Housing Development Agency Bond Finance Committee	Tennessee Local Development Authority
Governor	Governor	Comptroller	Governor
Comptroller	Comptroller	Treasurer	Comptroller
Treasurer	Treasurer	Secretary of State	Treasurer
Secretary of State	Secretary of State	Commissioner of F&A	Secretary of State
Commissioner of F&A	Commissioner of F&A	Chairman	Commissioner of F&A
	Chancellor of TN Board of Regents		House Appointee
	President of UT		Senate Appointee

Tennessee's General Obligation Debt

The General Assembly authorizes the issuance of bonds for a stated purpose, such as a capital project. This may be a state building or expansion of utility service at a state facility. It may also be a grant to a local development board to support economic development. These projects endure for several years so it makes sense to fund the project costs with long-term debt. This practice is known as financing a project over its useful life, or over the period of time that it will be utilized by the general public.

New bonds to be issued by the state are authorized by a "bond bill" that is acted upon by the General Assembly along with an appropriation bill. Last year the bond bill included grants for projects approved by the State Building Commission, as well as grants for economic development relating to the relocation of Hankook Tire America Corporation and Berretta USA to Tennessee.

The state constitution requires an appropriation for the first year's debt service on any bond issued. In addition to the appropriation for the first year's debt service on all outstanding debt, the General Assembly has honored the State Funding Board's request for a more stringent budgetary practice of annually appropriating with recurring funds at least 11 percent of the principal amount of all general obligation bonds that are authorized but unissued. (The 11 percent is based on a 20-year level principal amortization (5 percent) combined with an assumed rate of at least 6 percent interest. At least 6 percent is used as an assumed rate because no one can safely predict the interest rates at the time the bonds are actually sold). The State Funding Board insists on this budgetary practice so that the state will always have a ready source available to meet its obligations.

The State Funding Board's Debt Management Policy places additional requirements on the issuance of general obligation debt which in some instances can be overridden by unanimous vote of the State Funding Board.

- No general obligation bonds will be outstanding for longer than 20 years.
- All general obligation bonds will have at least equal principal repayments.
- Refunding bonds will be issued within the term of the originally issued debt.
- No backloading of principal is permitted.

These requirements are designed to keep the state from unduly postponing repayment of debt and "kicking the can down the road."

Tennessee also has a limitation on the total amount it can borrow, or its "debt capacity." Tennessee measures its debt capacity in terms of its maximum annual debt service, which is basically the largest principal and interest payment due in any one year on all general obligation debt outstanding. If the maximum annual debt service is greater than 10 percent of total state tax revenue, then no bonds can be issued. Total state tax revenue is defined as "those taxes, licenses, fees, fines and permits collected by the Department of Revenue and allocated to the general fund, debt service fund and the highway fund, excluding the portion of those taxes shared with local governments." This limitation is designed to keep the state from issuing too much debt.

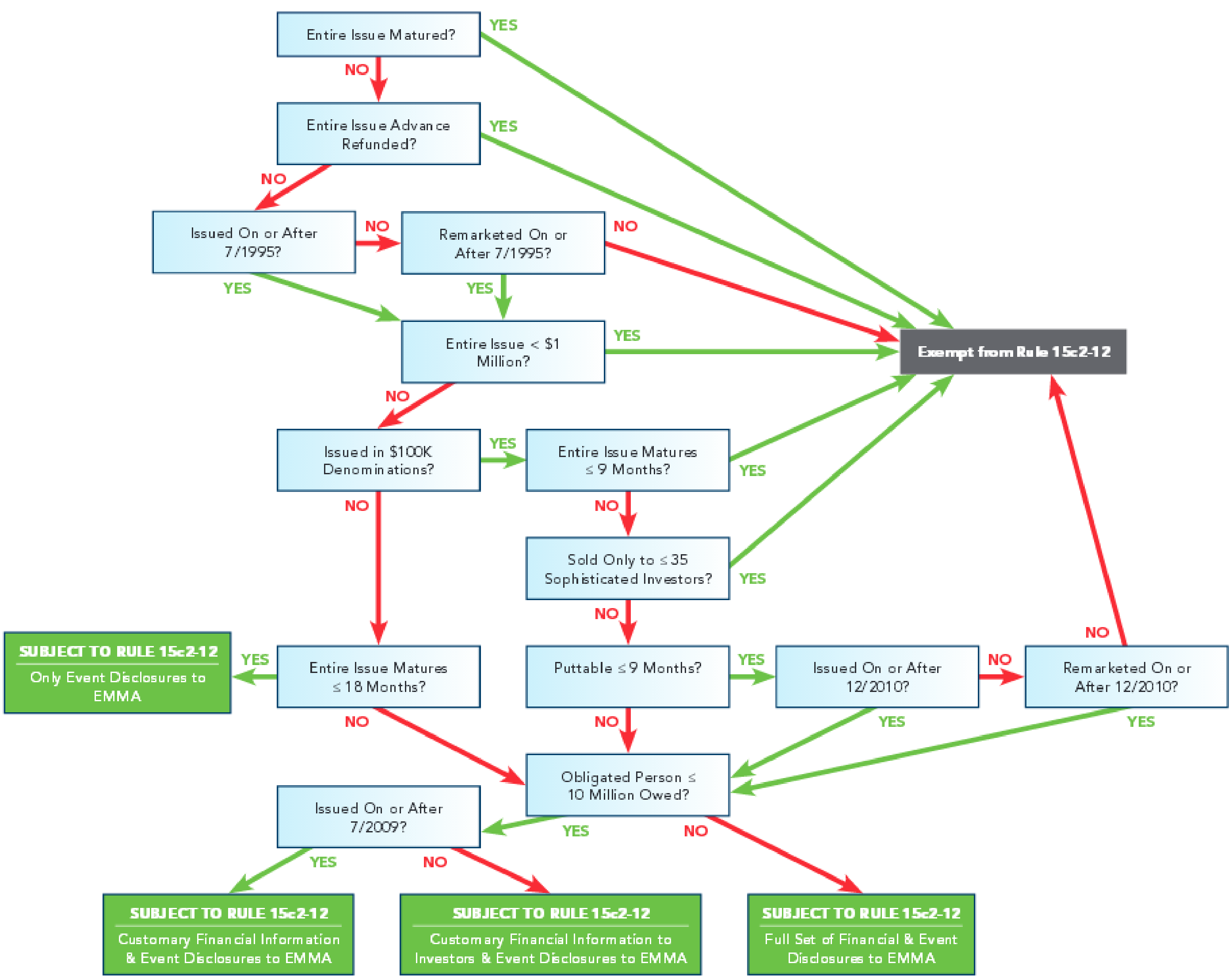
The State Funding Board issues short-term commercial paper to fund projects that have an average useful life of 10 years or less and to fund projects during the construction phase. Commercial paper can be issued incrementally as funds are needed and then paid through the issuance of long-term bonds as the projects are completed. Total outstanding commercial paper rarely exceeds 15 percent of Tennessee's total outstanding general obligation debt. This practice takes advantage of lower short-term interest rates and allows the State Funding Board to better match the timing of the issuance of the debt and the spending of proceeds. As a matter of policy, the State Funding Board does not fund long-term obligations with commercial paper.

The State of Tennessee does not issue bonds to finance highway construction or operating expenses.

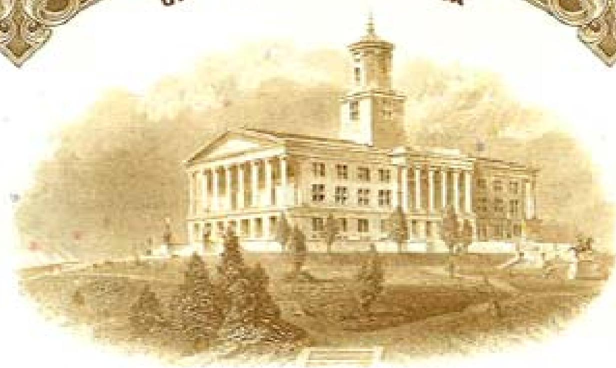
Depending on the intended use of the projects to be financed, Tennessee's general obligation debt can be issued as either "tax exempt," which means that the interest income to bondholders is generally exempt from federal income tax, or "taxable," which means that the interest income to bondholders is subject to federal income tax. Tax-exempt interest rates tend to be lower than taxable rates, but tax exempt bonds are subject to numerous requirements, regulations, and restrictions. Interest on all Tennessee general obligation debt is exempt from the Hall Income Tax.

Tennessee general obligation bonds are sold either by competitive sale or negotiated sale. In a competitive sale, the bonds are advertised by way of a notice of sale and bids are received at a specific time, and the sale is awarded to the bidder providing the lowest true interest cost. The State Funding Board prefers the competitive process, but recognizes that some bonds are best sold through negotiation. In a negotiated sale, the underwriter is chosen through a "Request for Proposal" process and the underwriter's fees are negotiated prior to the sale. The underwriter then sells the bonds to investors in the capital markets. Typical investors include individuals, banks, insurance companies, trusts, mutual funds, hedge funds, and corporations. Tennessee bonds are attractive to many investors because the interest income is often exempt from federal income tax, the state's full faith and credit is strong, and the projects that are financed with bond proceeds benefit the public.

Due to the complexity of bond transactions, many professionals are engaged through the debt issuance process—Bond Counsel, Issuer's Counsel, Underwriter's Counsel, Trustee's Counsel, and a Financial Advisor. In addition, federal law requires a high level of disclosure. Debt issuers like the State of Tennessee must sign a continuing disclosure undertaking each time bonds are sold. The following flowchart shows the different levels of disclosure that are required for certain types of transactions.



UNITED STATES OF AMERICA



NUMBER

5000

STATE OF TENNESSEE

Brief History of Tennessee Bonds

From Reconstruction Era railroad debt to recent economic development projects, a snapshot of our state's history and culture is found in our bond bills. The first major increase in state debt occurred between 1850 and 1870. The State of Tennessee issued bonds to help finance privately owned railroads. In exchange for the bond proceeds, the railroad companies pledged their income to the repayment of the debt. After the destruction of the Civil War, though, the railroads were unable to make their payments, which left the state bearing the burden.

Memphis and Charleston Locomotive 201

In response to the economic chaos after the railroads' default, Governor William Bate, on March 20, 1883, approved one of Tennessee's most important bond bills. The bill brought order to chaotic times by creating the State Funding Board, reaching a final settlement on the amount of railroad debt owed, and requiring a consistent form of bond. The State Funding Board as it exists today is one of Tennessee's leading financial policy makers—it manages the state's general obligation debt program and provides local governments with sound financial guidance.

The period of 1925-1931 is known as Tennessee's Highway Debt Period. Between 1927 and 1930, $47,200,000 of debt was incurred for highway construction and $13,850,000 was borrowed to build highway bridges. A major lobbying group during this time was the Tennessee Good Roads Association. Its slogan was "Lift Tennessee Out of the Mud."

Cumberland County road commissioner inspecting Highway 28 from Pikeville

The onset of the Great Depression abruptly halted these building efforts in 1931. Uncle Dave Macon memorialized the sentiment of the people of Tennessee at that time in the song, "Wreck of the Tennessee Gravy Train."

The people of Tennessee want to know who wrecked our gravy train.
The one we thought was run so well and now who can we blame?
They want to know who greased the track and started them down the road?
This same ol' train contained our money to build our highway roads.
But now we're up against it and no use to raise a row.
But of all the times I've ever seen, we're sure up against it now.
The only thing that we can do is to do the best we can.
Follow me, good people, I'm bound for the promised land.

THE GREAT SEAL OF THE STATE OF TENNESSEE
XVI
AGRICULTURE
COMMERCE
1796

UNITED STATES OF AMERICA

STATE OF TENNESSEE

In 1937, Governor Gordon Browning was elected to stabilize state finances. During his tenure, he consolidated the state's debt and reduced it by 40 percent. He also signed into law Public Chapter 165, Acts of 1937, which codified the state's first debt service limit and provided for state general obligation bonds. At that time, the state issued general obligation bonds primarily to finance the construction of highways and bridges. The state doubled its mileage of paved roads during Browning's governorship.

At the Limited Constitutional Convention of 1977, another in-depth review of Tennessee's financial laws took place. The delegates proposed more restrictions on state spending and debt issuance. The resulting amendment to Article II, Section 24, of the Tennessee Constitution introduced a spending limit and disallowed the issuance of state debt for operating expenses unless it was repaid within the fiscal year of issuance. The amendment was approved at the 1978 election.

> *No public money shall be expended except pursuant to appropriations made by law. Expenditures for any fiscal year shall not exceed the state's revenues and reserves, including the proceeds of any debt obligation, for that year. No debt obligation, except as shall be repaid within the fiscal year of issuance, shall be authorized for the current operation of any state service or program, nor shall the proceeds of any debt obligation be expended for a purpose other than that for which it was authorized.*
>
> *Any law requiring the expenditure of state funds shall be null and void unless, during the session in which the act receives final passage, an appropriation is made for the estimated first year's funding.*
>
> Excerpt from Tenn. Const. art. II, § 24

In 2013, the Tennessee General Assembly unanimously passed the Hawkins-Wilson Act, which clarified the state's general obligation pledge and created a clear debt service limit. Tennessee general obligation debt is now secured by all fees, taxes, and revenues allocated to the general, highway, and debt service funds. We take the repayment of our debt very seriously in Tennessee.

> ***"All bonds…shall constitute direct general obligations of the state of Tennessee for the payment of the principal of and premium, if any, and interest on which there is also pledged the full faith and credit of the state of Tennessee."***
>
> **The Hawkins-Wilson Act**

Tennessee's Credit Ratings

	Fitch	Moody's	S&P
State of TN (G.O.)	AAA	Aaa	AA+
TSSBA	AA+	Aa1	AA
TLDA	AA	Aa3	AA
THDA	Not Rated	Aa1	AA+

Credit ratings help investors decide which bonds or notes best suit their investment needs. Rating debt, however, is often as much an art as a science. The three major agencies that rate municipal debt do not use a strict formula when making these determinations; that is why the same series of bonds may have different ratings. Generally, though, financial, managerial, economic, and institutional factors are considered. A rating is assessed to the issuer and to the specific transaction and is intended to be forward looking. Moody's, in a recent publication on rating methodology, included the following scorecard showing how the different factors are weighted:

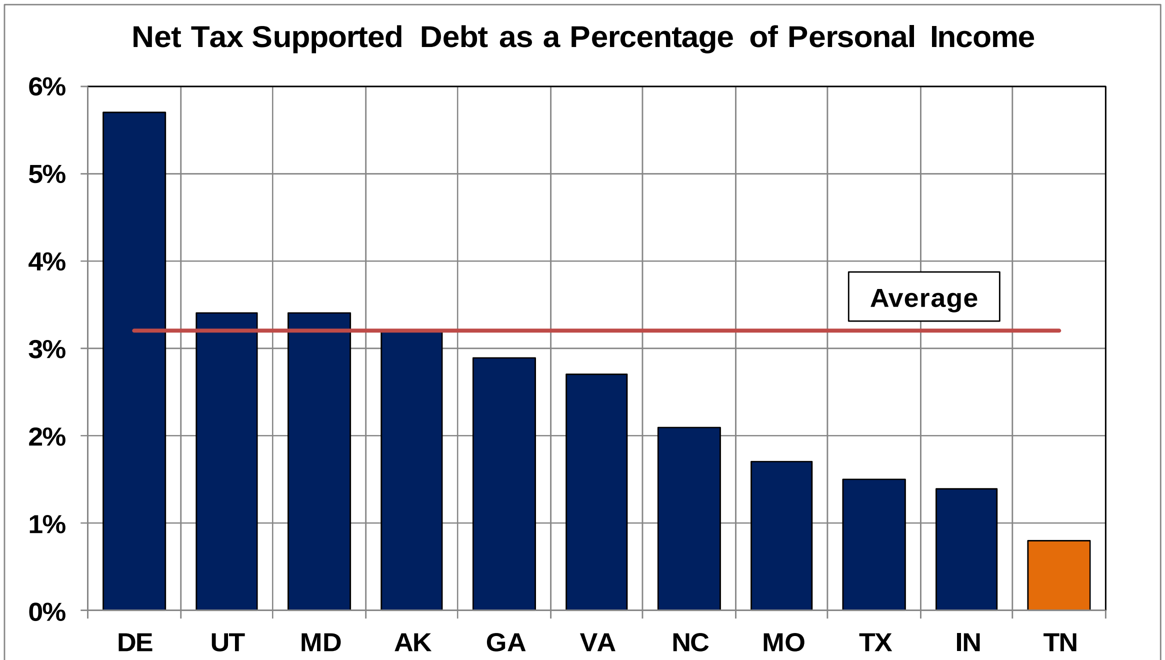
Broad Rating	Factor Weighting	Rating Sub-Factors	Sub-Factor
Economy	20%	Income	10%
		Industrial Diversity	5%
		Employment Volatility	5%
Governance	30%	Financial Best Practices	15%
		Financial Flexibility /	15%
		Constitutional Constraints	
Finances	30%	Revenues	10%
		Balances and Reserves	10%
		Liquidity	10%
Debt	20%	Bond Debt	10%
		Adjusted Net Pension Liabili-	10%
Total	100%		100%

Conservative financial practices have led Tennessee to have one of the lowest overall debt burdens in the country. While there are many ways to measure debt burden—using population, personal income, operating income, gross state product, including or excluding pension obligations, including or excluding debt of agencies such as TSSBA and THDA—Tennessee consistently ranks among the bottom five states. In fact, one rating agency, Fitch, ranks Tennessee as the lowest in overall debt which includes its pension obligations. Currently, Tennessee is projected to repay more than 66 percent of its outstanding g.o. debt within 10 years.

He that has lost his credit is dead to the world.

--English and German Proverb

Tennessee has actually decreased its long-term general obligation debt by over $175 million since June 30, 2012. Simply stated, Tennessee does not borrow much money and pays back the money it borrows quickly.



Tennessee has the Lowest Net Tax Supported Debt Compared to Other Highly Rated States
Source: Moody's

Conclusion

The State Funding Board has demonstrated its commitment to conservative financial management. General obligation debt is amortized over no more than 20 years with level principal payments. The State of Tennessee budgets for debt payments with recurring dollars. This kind of debt management practice lessens the potential for serious problems down the road.

Issuing debt in moderation is still one of the most equitable ways to finance many large capital projects because it spreads the costs evenly throughout the life of the project—it doesn't punish the current or future generations of Tennesseans. It also allows the state to make capital investments that it cannot afford to pay for in a single year. Everyone who benefits from the project pays for a portion of it.

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