Government Finance Officers Association of Texas

Promoting Excellence in Public Finance

Supplement to GAA

FIXED INCOME SECURITIES AS DEBT AND INVESTMENTS

Fixed Income Securities

Government Use of Fixed Income Securities

General governments are restricted in the types of investments they may hold

- Texas governments regulated by PFIA (Public Funds Investment Act) which allows:
  - Depository including long-term CDs
  - Investment Pools meeting certain requirements
  - Fixed Income securities meeting certain requirements
- Governments are allowed to borrow funds to finance long-term assets through:
  - Collateralized or uncollateralized private loans
  - Leases
  - Issuance of publicly held fixed income securities
    - Bonds
    - Certificates of Obligation
    - Commercial Paper (for short term interim financing)

Nature of Fixed Income Securities

Fixed Income securities have:

- Fixed maturity either a small number or more commonly year by year.
- Fixed rate for each year’s maturity
- Blended rate of all maturities and related interest rates are known as TIC (True Interest Cost)
- May be callable after a set number of years at a set price (10-year call at par common for municipals)

Are issued by:

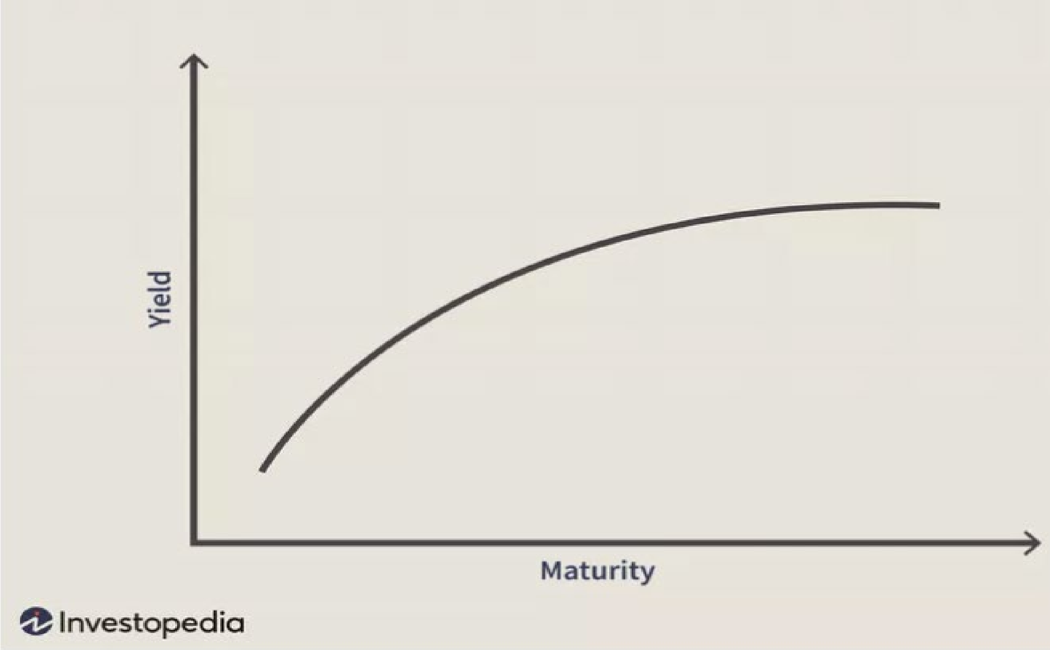
- State and Local governments (collectively referred to as municipals)
- Federal government (largest market) referred to as treasuries and agencies
- Private sector corporations
- At this point are entirely electronic/digital in nature

Digital “Paperless” Securities

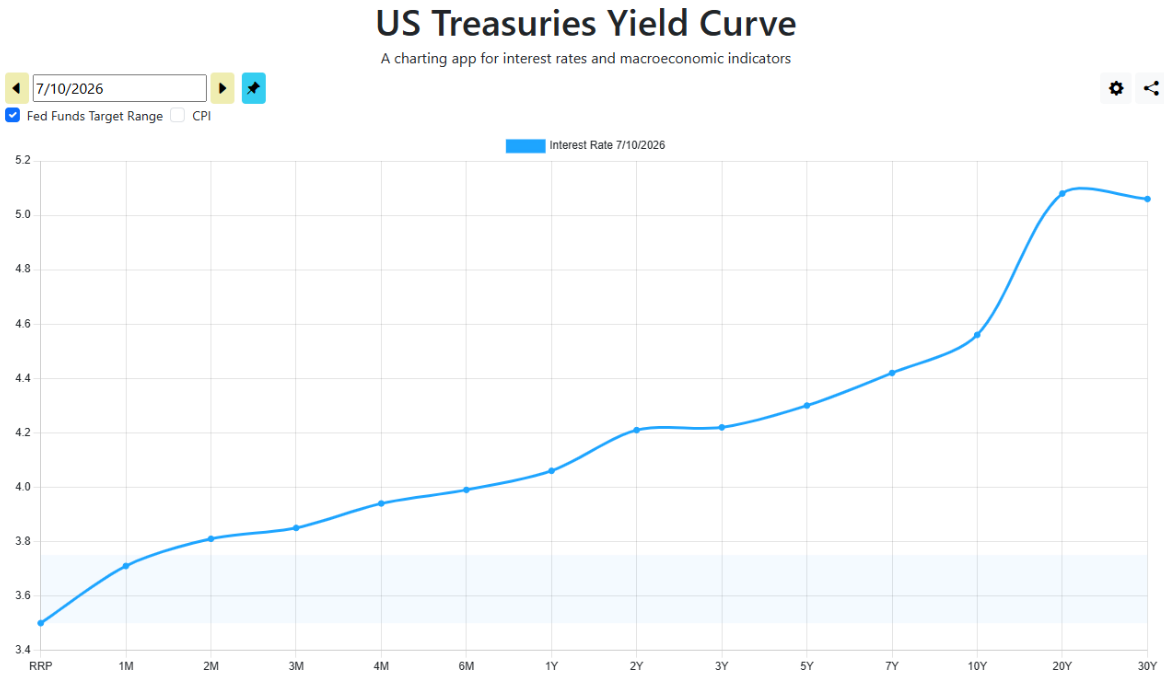
- Historically, fixed income securities were printed:
  - On high quality paper in very elaborate print to make forgery difficult
  - Ownership was proven by possession of the bond (bearer bonds)
  - Contained perforated “coupons” that could be removed from the security and turned into the bank to receive periodic interest payments
- Today everything is digital and is recorded either through a private service or for treasuries through the Federal Reserve System
  - The original issuer relies on custodians throughout the banking system to hold the securities through a series of primary and subsidiary accounts, not knowing who the actual owner of the security is.
  - Purchasers of securities prove/perfect ownership in the security by how it is being held and who holds it
  - If your security is being held in a broker/dealers trading account, and not a separate custodial account then you have not proven your ownership

Fixed Income Securities-Yield Curve

In general terms, the longer a fixed income security is outstanding, the higher the interest rate the market commands.



Investopedia / Julie Bang



Value Changes on Fixed Income Securities

- The interest rate market of publicly traded Fixed Income securities will change in value everyday
- Every time the market rate changes the value of a fixed rate security also changes
  - If market rate goes up, the existing security is worth less
  - If market rate goes down, the existing security is worth more
- These changes and the difference between the face value that the security will pay at maturity are known as “discounts” (worth less than face value) and premiums (worth more than face value).
- It is important to remember that the more time to final maturity of the security and the bigger the difference between the security’s rate of interest and market, the larger the discount or premium

Refundings

- It is almost always advantageous to refund debt close to or at the call date due for savings due to:
  - Most municipal debt issued with ten-year calls
  - Issued with coupon rates of 4% & 5% that generated an original issue premium
  - The move down the yield curve i.e. an eleven year maturity at issuance is now a one-year maturity.
- There are three ways to retire debt prior to maturity
  - Advanced Refunding (more than 90 days prior to the call date)
  - Current Refunding (90 days or less than date or past call date)
  - Redemption –paying off the debt with cash on hand

In Substance Defeasance

Advanced Refunding and even current refundings that hat have time left before the call date require use of an irrevocable trust resulting in an in-substance defeasance

Interest to call date
and pay off principal
at call date

Proceeds from New Debt
$1.1 million

Irrevocable Trust
With short term investments adequate to pay interest and principal

Old Debt $ 1 million

In this example, the new debt of $1.1 million replaces the old debt of $1 million with the resulting loss being amortized over the shorter of the remaining life of the old or new debt, If the old debt is outstanding at year end, the notes should disclose that it is defeased but outstanding.

Accounting Implications

- Municipal debt is normally issued at a premium or discount
  - In recent years in the low interest environment almost all municipal debt are issued with premiums. These must be amortized over the remaining life of the debt or to the call date.
  - Investments must be "marked" to market
  - Disclosure must be made regarding how the securities and pledged collateral are held (custodial risk), the weighted average maturity of the portfolio (market risk) and the credit worthiness of the portfolio (credit risk)