

S B

268

SENATE COMMITTEE REPORT

FURTHER FIN

4/14/89

DATE TURNED INTO OFFICE

4/20/89

Mr. President:

LABOR & COMMERCE

Committee considered

SB 268

municipal financing and municipal joint insurance arrangements; the Alaska Municipal Bond Bank Authority; efd

and recommended

- replace with _____ CS _____) same title
- or adopt _____ CS SB 268 (L+C)) new title
- attached amendment(s) and technical title change (HB only)
- _____ letter of intent adopted

do pass

do not pass

no recommendation

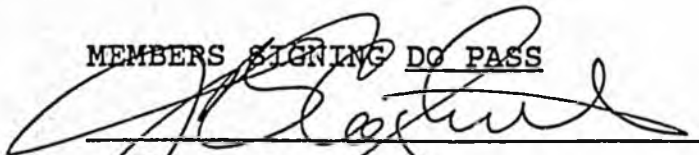
individual recommendations

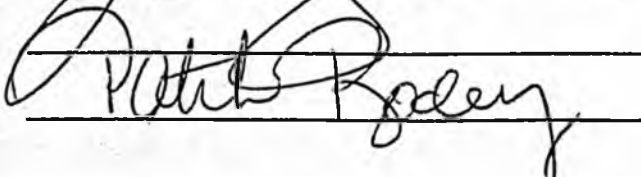
further referral to _____

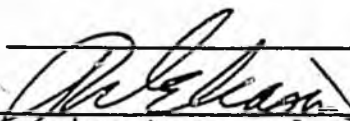
- ^{Commerce + Econ Dev 4/11/89}
FISCAL NOTE(S) zero fiscal impact appropriation no FN
 new updated previous
 same as previous fiscal note(s) published _____

MEMBERS SIGNING DO PASS

OTHER RECOMMENDATIONS





 Do Pass

 Chairman signature and recommendation

Committee Backup attached

Original sponsors: Frank, Sturgulewski,
Adams, et al.

BY THE LABOR AND
COMMERCE COMMITTEE

1 IN THE SENATE

2 CS FOR SENATE BILL NO. 268 (L&C)

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 SIXTEENTH LEGISLATURE - FIRST SESSION

5 A BILL *slight change in title*

6 For an Act entitled: "An Act relating to joint insurance arrangements,
7 municipal financing, and the Alaska Municipal Bond
8 Bank Authority; and providing for an effective date."

9 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

10 * Section 1. FINDING AND PURPOSE. (a) The legislature finds that
11 dramatic increases in the cost of liability and other insurance coverage
12 for municipalities has adversely affected municipal budgets, and that even
13 at increased premiums, insurance coverage is often not available to cover
14 important liability exposure.

15 (b) The purpose of this Act is to allow municipalities and municipal
16 joint insurance arrangements organized under AS 21.76 to utilize debt
17 financing to establish reserves to self-insure against liability, when the
18 cost of excess insurance or reinsurance is too high.

19 * Sec. 2. AS 21.76.020 is repealed and reenacted to read:

20 Sec. 21.76.020. REGULATION BY DIVISION OF INSURANCE AND ANNUAL
21 REPORT. (a) A joint insurance arrangement may not be considered
22 insurance for the purpose of any other law of the state and is not
23 subject to regulations adopted by the director.

24 (b) By October 1 of each year the administrator of a joint
25 insurance arrangement shall prepare and deliver to the Legislative
26 Budget and Audit Committee a report showing the true and correct
27 financial condition of the joint insurance arrangement. The report
28 must

29 (1) be attested to by the administrator and the board of

1 directors;

2 (2) include an analysis certified by a member of the Ameri-
3 can Academy of Actuaries, of the sufficiency of the loss reserves; and

4 (3) be certified by a certified public accountant.

5 * Sec. 3. AS 21.76.080(b) is amended to read:

6 (b) An expenditure may be made from a joint insurance fund only
7 to

8 (1) pay claims, losses, or benefits, including interest on
9 them, and the administrative and adjustment expenses incurred in
10 connection with them, involving the types of protection for which the
11 fund provides coverage as specified in the joint insurance agreement;

12 (2) pay contractual obligations of a joint insurance fund
13 established by a municipal joint insurance arrangement to the Alaska
14 Municipal Bond Bank Authority or other lender; and

15 (3) purchase insurance coverage for members of a municipal
16 joint insurance arrangement on a group basis.

17 * Sec. 4. AS 21.76 is amended by adding a new section to read:

18 Sec. 21.76.120. DEBT FINANCING. (a) A municipality or a munic-
19 ipal joint insurance arrangement may authorize the issuance of nego-
20 tiable or nonnegotiable notes or certificates of participation to
21 establish reserves and to self-insure against liability not covered by
22 excess insurance or reinsurance. A note or certificate issued under
23 this subsection by a municipal joint insurance arrangement shall be
24 secured and payable from participating members of the municipal joint
25 insurance arrangement as provided in the cooperative agreement.

26 (b) A municipality that has entered into a municipal joint
27 insurance arrangement may enter into contracts and agreements concern-
28 ing debt issued under (a) of this section and provide for matters that
29 affect the security of the debt. Notes and certificates of

1 participation issued under (a) of this section may be sold at either
2 public or private sale as provided by the participants in the municipi-
3 pal joint insurance arrangement in the manner and at the price the
4 participants determine.

5 * Sec. 5. AS 37.10.085 is amended by adding a new subsection to read:

6 (b) This section does not apply to debt issued by a municipality
7 or a municipal joint insurance arrangement under AS 21.76.120.

8 * Sec. 6. AS 44.85.010(a) is amended to read:

9 (a) It is the policy of the state

10 (1) to foster and promote by all reasonable means the
11 provision of adequate capital markets and facilities for borrowing
12 money by municipalities in the state to finance capital improvements
13 or for other authorized purposes, to assist these municipalities in
14 fulfilling their capital needs and requirements by use of borrowed
15 money within statutory interest rate or cost of borrowing limitations,
16 to the greatest extent possible to reduce costs of borrowed money to
17 taxpayers and residents of the state, and equally to encourage contin-
18 ued investor interest in the purchase of bonds or notes of municipal-
19 ities as sound and preferred securities for investment;

20 (2) to encourage municipalities to continue their indepen-
21 dent undertakings and financing of capital improvements and other
22 authorized purposes and to assist them by making capital funds avail-
23 able at reduced interest costs for orderly financing of capital im-
24 provements and other purposes especially during periods of restricted
25 credit or money supply, particularly for those municipalities not
26 otherwise able to borrow for capital needs;

27 (3) to assist municipalities to provide for adequate insur-
28 ance coverage by authorizing the Alaska Municipal Bond Bank Authority
29 to issue negotiable or nonnegotiable revenue bonds, notes, or

1 certificates of participation either directly or through an entity it
2 may create for the purpose of providing a self-insurance program for
3 municipalities or municipal joint insurance arrangements organized
4 under AS 21.76.

5 * Sec. 7. AS 44.85.080 is amended by adding a new paragraph to read:

6 (21) ^{was resolution} by regulation, create a new entity for the purpose of
7 issuing negotiable or nonnegotiable revenue bonds, notes, or certifi-
8 cates of participation to finance a self-insurance program for munic-
9 ipalities or municipal joint insurance arrangements organized under
10 AS 21.76; the powers, duties, and membership of the new entity shall
11 be limited to the powers, duties, and membership of the authority and
12 stated in the ^{was resolution} regulation; the new entity shall be a public corporation
13 and an instrumentality of the state with the same legal existence and
14 continuing succession as the bond bank authority.

15 * Sec. 8. AS 44.85.170 is amended to read:

16 Sec. 44.85.170. LOANS TO POLITICAL SUBDIVISIONS AND JOINT INSUR-
17 ANCE ARRANGEMENTS. (a) The bond bank authority, to carry out the
18 purposes and policies of this chapter, may lend money to municipal-
19 ities through the purchase by the bond bank authority of municipal
20 bonds of municipalities and if the purpose of the loan is to provide
21 financing for a municipal self-insurance program and the loan meets
22 the credit standards of the bond bank authority, may lend money to
23 municipalities, or municipal joint insurance arrangements organized
24 under AS 21.76. Notwithstanding a home rule charter provision re-
25 quiring public sale by a municipality of its municipal bonds, a munic-
26 ipality may sell its municipal bonds to the bond bank authority at a
27 negotiated, private sale. The bond bank authority, for this purpose,
28 may issue its bonds and notes payable solely from the revenues or
29 funds available to the bond bank authority for such payment and may

1 otherwise assist municipalities as provided in this chapter.

2 (b) Notwithstanding any other provision of law, to the extent
3 that any department or agency of the state is the custodian of money
4 payable to a municipality, at any time after written notice to the
5 department or agency head from the bond bank authority that the munic-
6 ipality is in default on the payment of principal or interest on
7 municipal bonds then held or owned by the bond bank authority, or
8 amounts due under an agreement between the bond bank authority and a
9 municipality or a municipal joint insurance arrangement organized
10 under AS 21.76, the department or agency shall withhold the payment of
11 that money from that municipality and pay over the money to the bond
12 bank authority for the purpose of paying principal of and interest on
13 the bonds or debt.

14 * Sec. 9. AS 44.85.180(a) is amended to read:

15 (a) Subject to AS 44.85.100(b), the bond bank authority may
16 issue its bonds or notes in principal amounts that it considers neces-
17 sary to provide funds for any purposes under this chapter, including

18 (1) the purchase of municipal bonds;

19 (2) the making of loans through the purchase of municipal
20 bonds, notes, or certificates of participation secured by an agreement
21 between the bond bank authority and a municipality or a municipal
22 joint insurance arrangement organized under AS 21.76;

23 (3) the payment, funding or refunding of the principal of,
24 or interest or redemption premiums on, bonds or notes issued by it
25 whether the bonds or notes or interest to be funded or refunded have
26 or have not become due;

27 (4) the establishment or increase of reserves to secure or
28 to pay bonds or notes or interest on bonds or notes and all other
29 costs or expenses of the bond bank authority incident to and necessary

1 or convenient to carry out its corporate purposes and powers.

2 * Sec. 10. This Act takes effect immediately under AS 01.10.070(c).
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Offered: 4/14/89
Referred: Labor and Commerce
and Finance

6-0814E

Original sponsors: Frank, Sturgulewski,
Adams, et al.

1 IN THE SENATE

BY THE COMMUNITY AND REGIONAL
AFFAIRS COMMITTEE

2 CS FOR SENATE BILL NO. 268 (C&RA)

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 SIXTEENTH LEGISLATURE - FIRST SESSION

5 A BILL

6 For an Act entitled: "An Act relating to municipal financing and municipal
7 joint insurance arrangements; the Alaska Municipal
8 Bond Bank Authority; and providing for an effective
9 date."

10 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

11 * Section 1. FINDING AND PURPOSE. (a) The legislature finds that
12 dramatic increases in the cost of liability and other insurance coverage
13 for municipalities has adversely affected municipal budgets, and that even
14 at increased premiums, insurance coverage is often not available to cover
15 important liability exposure.

16 (b) The purpose of this Act is to allow municipalities and municipal
17 joint insurance arrangements organized under AS 21.76 to utilize debt
18 financing to establish reserves to self-insure against liability, when the
19 cost of excess insurance or reinsurance is too high.

20 * Sec. 2. AS 21.76.020 is amended by adding a new subsection to read:

21 (e) If member contributions or debt financing of a municipal
22 joint insurance arrangement is used to establish reserves or to self-
23 insure against liability not covered by excess insurance or reinsur-
24 ance, evidence of assets allowable under (c)(3) of this section may be
25 used in place of or to supplement the certificates required under
26 (c)(1) and (2) of this section.

27 * Sec. 3. AS 21.76.030 is amended by adding a new subsection to read:

28 (b) A cooperative agreement between members of a municipal joint
29 insurance arrangement that pledges money to pay bonds of the Alaska
S

1 Municipal Bond Bank Authority is not subject to regulations of the
2 director and may contain other or different provisions from those
3 required under (a) of this section.

4 * Sec. 4. AS 21.76.080(b) is amended to read:

5 (b) An expenditure may be made from a joint insurance fund only
6 to

7 (1) pay claims, losses, or benefits, including interest on
8 them, and the administrative and adjustment expenses incurred in
9 connection with them, involving the types of protection for which the
10 fund provides coverage as specified in the joint insurance agreement;

11 (2) pay contractual obligations of a joint insurance fund
12 established by a municipal joint insurance arrangement to the Alaska
13 Municipal Bond Bank Authority or other lender; and

14 (3) purchase insurance coverage for members of a municipal
15 joint insurance arrangement on a group basis.

16 * Sec. 5. AS 21.76 is amended by adding a new section to read:

17 Sec. 21.76.120. DEBT FINANCING. (a) A municipality or a munic-
18 ipal joint insurance arrangement may authorize the issuance of nego-
19 tiable or nonnegotiable notes or certificates of participation to
20 establish reserves and to self-insure against liability not covered by
21 excess insurance or reinsurance. A note or certificate issued under
22 this subsection by a municipal joint insurance arrangement shall be
23 secured and payable from participating members of the municipal joint
24 insurance arrangement as provided in the cooperative agreement.

25 (b) A municipality that has entered into a municipal joint
26 insurance arrangement may enter into contracts and agreements concern-
27 ing debt issued under (a) of this section and provide for matters that
28 affect the security of the debt. Notes and certificates of participa-
29 tion issued under (a) of this section may be sold at either public or

1 private sale as provided by the participants in the municipal joint
2 insurance arrangement in the manner and at the price the participants
3 determine.

4 * Sec. 6. AS 37.10.085 is amended by adding a new subsection to read:

5 (b) This section does not apply to debt issued by a municipality
6 or a municipal joint insurance arrangement under AS 21.76.120.

7 * Sec. 7. AS 44.85.010(a) is amended to read:

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9 (1) to foster and promote by all reasonable means the
10 provision of adequate capital markets and facilities for borrowing
11 money by municipalities in the state to finance capital improvements
12 or for other authorized purposes, to assist these municipalities in
13 fulfilling their capital needs and requirements by use of borrowed
14 money within statutory interest rate or cost of borrowing limitations,
15 to the greatest extent possible to reduce costs of borrowed money to
16 taxpayers and residents of the state, and equally to encourage contin-
17 ued investor interest in the purchase of bonds or notes of municipal-
18 ities as sound and preferred securities for investment;

19 (2) to encourage municipalities to continue their indepen-
20 dent undertakings and financing of capital improvements and other
21 authorized purposes and to assist them by making capital funds avail-
22 able at reduced interest costs for orderly financing of capital im-
23 provements and other purposes especially during periods of restricted
24 credit or money supply, particularly for those municipalities not
25 otherwise able to borrow for capital needs;

26 (3) to assist municipalities to provide for adequate insur-
27 ance coverage by authorizing the Alaska Municipal Bond Bank Authority
28 to issue negotiable or nonnegotiable revenue bonds, notes, or certifi-
29 cates of participation either directly or through an entity it may

1 create for the purpose of providing a self-insurance program for
2 municipalities or municipal joint insurance arrangements organized
3 under AS 21.76.

4 * Sec. 8. AS 44.85.080 is amended by adding a new paragraph to read:

5 (21) by resolution, create a new entity for the purpose of
6 issuing negotiable or nonnegotiable revenue bonds, notes, or certifi-
7 cates of participation to finance a self-insurance program for munic-
8 ipalities or municipal joint insurance arrangements organized under
9 AS 21.76; the powers, duties, and membership of the new entity shall
10 be limited to the powers, duties, and membership of the authority and
11 stated in the resolution; the new entity shall be a public corporation
12 and an instrumentality of the state with the same legal existence and
13 continuing succession as the bond bank authority.

14 * Sec. 9. AS 44.85.170 is amended to read:

15 Sec. 44.85.170. LOANS TO POLITICAL SUBDIVISIONS AND JOINT INSUR-
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17 purposes and policies of this chapter, may lend money to municipal-
18 ities through the purchase by the bond bank authority of municipal
19 bonds of municipalities and if the purpose of the loan is to provide
20 financing for a municipal self-insurance program and the loan meets
21 the credit standards of the bond bank authority, may lend money to
22 municipalities, or municipal joint insurance arrangements organized
23 under AS 21.76. Notwithstanding a home rule charter provision re-
24 quiring public sale by a municipality of its municipal bonds, a munic-
25 ipality may sell its municipal bonds to the bond bank authority at a
26 negotiated, private sale. The bond bank authority, for this purpose,
27 may issue its bonds and notes payable solely from the revenues or
28 funds available to the bond bank authority for such payment and may
29 otherwise assist municipalities as provided in this chapter.
S

1 (b) Notwithstanding any other provision of law, to the extent
2 that any department or agency of the state is the custodian of money
3 payable to a municipality, at any time after written notice to the
4 department or agency head from the bond bank authority that the munic-
5 ipality is in default on the payment of principal or interest on
6 municipal bonds then held or owned by the bond bank authority, or
7 amounts due under an agreement between the bond bank authority and a
8 municipality or a municipal joint insurance arrangement organized
9 under AS 21.76, the department or agency shall withhold the payment of
10 that money from that municipality and pay over the money to the bond
11 bank authority for the purpose of paying principal of and interest on
12 the bonds or debt.

13 * Sec. 10. AS 44.85.180(a) is amended to read:

14 (a) Subject to AS 44.85.100(b), the bond bank authority may
15 issue its bonds or notes in principal amounts that it considers neces-
16 sary to provide funds for any purposes under this chapter, including

17 (1) the purchase of municipal bonds;

18 (2) the making of loans through the purchase of municipal
19 bonds, notes, or certificates of participation secured by an agreement
20 between the bond bank authority and a municipality or a municipal
21 joint insurance arrangement organized under AS 21.76;

22 (3) the payment, funding or refunding of the principal of,
23 or interest or redemption premiums on, bonds or notes issued by it
24 whether the bonds or notes or interest to be funded or refunded have
25 or have not become due;

26 (4) the establishment or increase of reserves to secure or
27 to pay bonds or notes or interest on bonds or notes and all other
28 costs or expenses of the bond bank authority incident to and necessary
29 or convenient to carry out its corporate purposes and powers.

1 * Sec. 11. This Act takes effect immediately under AS 01.10.070(c).
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STATE OF ALASKA
1989 LEGISLATIVE SESSION

BILL VERSION: SB 268
PUBLISH DATE: 4/14/89

FISCAL NOTE

REQUEST:

Revision Date: _____ Agency Affected: Commerce & Economic Dev.
Title: An Act relating to municipal BRU: Insurance
financing and municipal joint arrangements
Sponsor: Frank, Sturgulewski, et al. Components: _____
Requester: Senate C&RA

EXPENDITURES / REVENUES : (Thousands of Dollars)

OPERATING	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	0	0	0	0	0	0

CAPITAL	0	0	0	0	0	0
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REVENUE	0	0	0	0	0	0
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FUNDING: (Thousands of dollars)

GENERAL FUND						
FEDERAL FUNDS						
OTHER						
TOTAL	0	0	0	0	0	0

POSITIONS:

FULL-TIME	0	0	0	0	0	0
PART-TIME						
TEMPORARY						

ANALYSIS: (Attach a separate page if necessary.)

This fiscal note is appropriate for CS SB268 (L+C).

Sheila Peterson
Senate Labor + Commerce

Prepared by: Joan Brown, Administrative Officer
Division: Insurance

Phone: 465-2515
Date: 4-11-89

Approved by Commissioner: Larry Mercurieff *S.M.*
Agency: Department of Commerce & Economic Development

Phone: 465-2500
Date: 4/12/89

Distribution (by preparer):

- Legislative Finance
- Legislative Sponsor
- Requestor
- Office of Management and Budget
- Impacted Agency(ies)

STATE OF ALASKA

DEPARTMENT OF LAW

OFFICE OF THE ATTORNEY GENERAL

STEVE COWPER, GOVERNOR

REPLY TO:

1031 W 4th AVENUE
SUITE 200
ANCHORAGE, ALASKA 99501-1994
PHONE: (907) 276-3550

1st NATIONAL CENTER
100 CUSHMAN ST
SUITE 400
FAIRBANKS, ALASKA 99701-4679

P.O. BOX K—STATE CAPITOL
JUNEAU, ALASKA 99811-0300
PHONE: (907) 465-3600

April 17, 1989

Hon. Steve Frank
Alaska State Legislature
P.O. Box K
Juneau, AK 99811

Re: SB 268 -- joint municipal
insurance

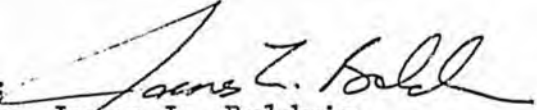
Dear Senator Frank:

I have reviewed the changes proposed for SB 268 to meet my concerns about excessive delegation of the power to create instrumentalities. I believe that the amendments proposed by Eric Wohlforth will limit and give standards for the Municipal Bond Bank Authority to create a new bond issuing entity. However, I recommend that the entity be created by regulation rather than resolution. To adopt a regulation, the authority would need to follow the adoption procedures set out in the Administrative Procedure Act when it creates the entity. Under the resolution adoption process, the opportunity for public participation could be limited. The regulation adoption process also includes notice and an opportunity to comment for legislators. To meet this concern, the draft committee substitute, at page 4, lines 5 and 11, should be changed from "resolution" to read: "regulation."

I hope that you will find these comments useful.

Sincerely yours,

DOUGLAS B. BAILY
ATTORNEY GENERAL

By: 
James L. Baldwin
Assistant Attorney General

JLB/pjg

cc: Arthur Peterson
Dept. of Law -- Juneau
Eric Wohlforth, Esq.
Wohlforth, Argetsinger,
Johnson & Brecht

STATE OF ALASKA

DEPT. OF COMMUNITY & REGIONAL AFFAIRS

OFFICE OF THE COMMISSIONER

April 12, 1989

POSITION PAPER

RE: Senate Bill 268

SPONSOR: Senator Frank

Program Effects

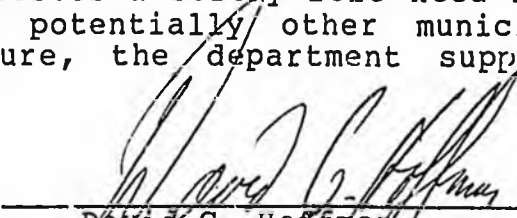
This bill would authorize municipalities and municipal joint insurance arrangements to use debt financing to establish reserves for self insurance. It would also authorize the Municipal Bond Bank to underwrite this debt through the sale of bonds.

Comments

The Alaska Municipal League Joint Insurance Association (JIA) is a joint insurance arrangement of municipalities created to respond to the problems experienced by municipalities in securing reasonably affordable insurance coverage in the past. While the cost of insurance has fallen some from its peak a few years ago, in light of the cyclical nature of the insurance market, the JIA is a needed institution to provide a stable source of insurance for the members.

By allowing the JIA and municipalities to utilize debt financing for excess insurance and reinsurance, this legislation protects the JIA and member municipalities from future market conditions which could lead to the unavailability of such insurance at a reasonable cost. While such financing is not critical at this time, it provides a response to such an event in the future.

Because this legislation addresses a sorely felt need for these affected municipalities and potentially other municipalities which may join in the future, the department supports the concept of this legislation.



David G. Hoffman
Commissioner

STEVE COWPER, GOVERNOR

- P.O. BOX B
JUNEAU, ALASKA 99811-2100
PHONE: (907) 485-4700
- 949 E. 36TH AVENUE, SUITE 400
ANCHORAGE, ALASKA 99508-4302
PHONE: (907) 583-1073

STATE OF ALASKA
THE LEGISLATURE

POUCHY STATE CAPITOL
JUNEAU ALASKA 99801
907 465 3800

LEGISLATIVE AFFAIRS AGENCY

MEMORANDUM

April 13, 1989

SUBJECT: Municipal debt financing - SB 268
TO: Senator Steve Frank
FROM: Michael F. Ford *m.f.*
Legislative Counsel

The following is a sectional analysis of SB 268:

Section 1 - Finding and purpose.

Section 2 - Allows certain evidence of assets to be used in place of or to supplement required insurance certificates, if a municipal joint insurance arrangement uses member contributions or debt financing to establish reserves or to self-insure against liability.

Section 3 - Excludes a cooperative agreement between members of a municipal joint insurance arrangement that pledges money to pay bonds, from regulation by the director of the division of insurance, and provides that the agreement may contain other or different provisions than specified in AS 21.76.030(a).

Section 4 - Allows expenditures from a joint insurance fund to pay contractual obligations to certain lenders, and for the purchase of insurance.

Section 5 - Allows a municipality or a municipal joint insurance arrangement to contract debt for the purpose of self-insuring against liability. Provides that the municipality or joint insurance arrangement may enter into contracts concerning the debt, and may sell notes or certificates of participation at public or private sale as provided by the participants.

Section 6 - Excludes debt issued by a municipality or a municipal joint insurance arrangement from the provisions of AS 37.10.085, concerning prohibited debt issued to a corporation.

Senator Steve Frank

Page 2

April 13, 1989

Section 7 - Adds a provision that assisting municipalities to provide insurance coverage through bonds or other debt issued by the Alaska Municipal Bond Bank Authority, is included as the policy of the state.

Section 8 - Authorizes the Alaska Municipal Bond Bank Authority to create a new entity for the purpose of financing a self-insurance program for municipalities or municipal joint insurance arrangements.

Section 9 - Authorizes the Alaska Municipal Bond Bank Authority to lend money to municipalities, or municipal joint insurance arrangements for the purpose of financing a self-insurance program.

Section 10 - Authorizes the Alaska Municipal Bond Bank Authority to make loans by purchasing notes or certificates of participation from a municipality or a municipal joint insurance arrangement.

Section 11 - Effective date.

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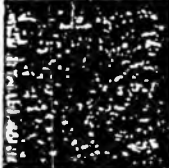
wkk4/001

Bond-Financed Self-Insurance for Public Entities

by the Chicago Chapter, The Society of CPCU

ABSTRACT: *This paper was written to assist public entity risk managers and brokers in the development of an alternate approach to traditional risk management problems faced by public entities. Although there is a quantity of information available on both risk management techniques, in particular on retention plans and public finance, until recently there was practically no information available on the use of public finance and risk management techniques in combination. The purpose of this paper is to begin to fill that void.*

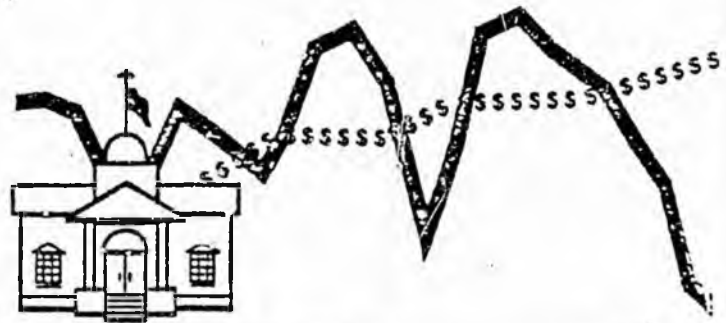
Statement of the Problem

 cyclicity. Insurance cycles have affected both the insurance industry and the insurance buyers for over 100 years. To the extent that these cycles can be predicted, the effects of the cycles can be managed. Given recent trends, the familiar cycle of three years of lax underwriting standards, excess capacity and the negotiable prices of cash-flow underwriting followed by three years of tight markets, strained capacity, sound underwriting and carefully managed growth is disappearing and is being replaced with cycles of erratic lengths and of increasing magnitudes of heights and depths.

Planning, Budgeting and Deficits. The insurance cycle creates a problem in planning and budgeting for public

The Chicago Chapter of The Society of CPCU submitted this paper in May of 1987, and it received the Outstanding Research Project Award. The Research Committee consists of Richard G. Rudolph, CPCU; John Duify, CPCU; Daniel Kaminski, CPCU; Megan Mevring, CPCU; and Jill Nelson, CPCU.

The committee wishes to acknowledge the assistance provided by Gerard Fernandez, Jr., Anne Beddingfield, Mark Abrams, Steven Hoffman, Thomas C. Brophy, Edward Costner, ACAS, MAAA, and Bruce G. Fernandez. In one way or another, each provided expertise and help to the committee in the preparation of this paper.



“
... The insurance cycle creates
a problem in planning and
budget for public entities...
”

entities. Unlike private enterprise, a governmental entity, relying on taxation for its revenue, cannot raise its “price” for its services whenever its costs increase. Once the tax levy is set for the coming year, there is little that can be done to recover, in the current year, for sharply escalating costs. Instead, the public entity may be forced to operate at a deficit and make its recovery of the excess costs in future years.

This fact creates political difficulties, as taxpayers are more and more sensitive to the actions and reactions of their elected officials, and such increases may be met

with taxpayer lawsuits, adverse publicity, taxpayer revolt in the form of referendum-type propositions and opposition at re-election time.

Capacity. Another problem created by the insurance cycle is the variability of capacity, as expressed by the industry's changing attitude concerning its willingness to insure certain exposures and to provide sufficient limits to adequately cover exposures which will be insured. Taxpayers are highly sensitive to cutbacks in public services provided, even though the insurance needed to support the activities is unavailable or economically not feasible. Yet, no public official desires to provide uninsured or inadequately insured exposures to his electorate, for then he may be charged with failing to discharge his duty in properly protecting the public entity's interests. With continued erosion of sovereign immunity by a liberal legal system intent upon providing a system of social welfare, the public official faces society's two-edged Sword of Damocles, subject to suits if he buys insurance and subject to suits if he does not.

Summary. The problems faced by public entities are not new to this particular cycle. Public entities have never been on most insurers' target accounts lists. While some insurers have specialized in public entity business, most treat the business as agency accommodation or write the entity in a spirit of civic-mindedness. With the pressure put upon financial results by investors, particularly the financial service conglomerates, upon statutory results by regulators and legislators and upon the industry itself out of fear of widespread insolvency and capital impairment, agency accommodation and civic duty has taken a back seat to cancellation and nonrenewal notices. The future appears no brighter, as the reinsurers appear to be reluctant to assume public entity exposures, and the primary carriers can still afford to pick and choose the risks they wish to write with little fear of competition.

Current Alternatives for Solving the Problem

The Traditional Approach. The traditional approach to protecting a public entity for its exposures to loss centers around insurance or self-insurance if the entity is of sufficient size, or a combination of both. Typically, insurance contracts are written for most property exposures, except perhaps for automobile physical damage, all liability exposures, including professional or errors and omissions, excess liability coverages, and workers' compensation. Unemployment compensation is gener-

ally provided by a state-sponsored insurance program. Employee benefit programs are typically provided with insurance contracts or combinations of insurance and subscriber-type plans.

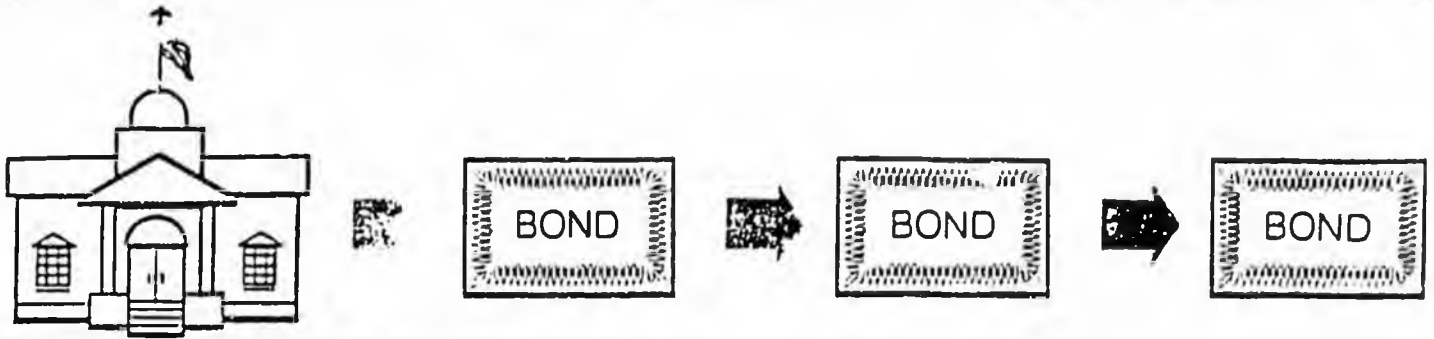
Larger public entities typically will deviate from the above by retaining some or all of their general liability exposures, workers' compensation, unemployment compensation and employee medical benefit plans. In other words, if they retained, they have tended to retain the exposures that are of relatively high and predictable frequency and low and calculable severity.

The Advantages of Insurance. When municipalities insure, they enjoy the advantages of a relatively predictable maximum cost for the policy year. Their potential payouts are capped by the premiums and deductibles. In addition, the municipality can receive services from the insurers, such as loss control and claims administration and settlement. When the insurance cycle is in its competitive phase, municipalities may be able to purchase coverage for a premium which is less than their expected losses.

The Disadvantages of Insurance. Insurance companies are driven by a profit motive and a survival motive (at times it is unclear which is dominant). Premiums charged include profit loadings, contingency loadings, premium taxes levied to finance regulation, insolvency funds and other funds, such as workers' compensation second-injury funds. The municipality is not exempt from these taxes, unlike most other taxes or levies. The insurers' profit/survival motives can create such variance in pricing of the coverages that the premium determination process creates budgetary and planning difficulties and impossibilities for the public entity.

The control of the programs is not in the hands of the insured or its representative, and so the entity must bow to the changing winds of underwriting philosophy and endure in some fashion cancellations, nonrenewals and notification of restrictions of coverage. The public official may be placed in the paradoxical position of refusing an outlandishly high premium, which would bring on a taxpayer suit if accepted, for a line of coverage which is needed to protect him when he is sued for not having the coverage in place, and which would likely be cancelled or renewed at an even higher premium if the taxpayer suit is brought.

The Advantages of Self-Insurance. To the extent the volatility of both pricing and coverage availability is either avoided or lessened by distancing an entity from the insur-



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ance market, self-insurance has an advantage over traditional insurance. The greater the distance between the protected entity and the insurance market, as measured by the retention, the greater the control the protected entity has over its risk management program.

Since insurance premiums are significantly reduced, if not eliminated in a self-insurance program, cost factors such as an insurer profit margin, contingency margin and premium tax are not incurred, thus enhancing the efficiency of the risk management program dollar, as more of the allocated funds are available to pay claims.

The Disadvantages of Self-Insurance. To the extent that there is excess insurance, there is a likelihood of exclusions, limitations, and other restrictions that evidence a lack of program control by the protected entity and the possibility of uncovered exposures.

There may be a program cost volatility that is greater than that of traditional insurance price volatility, as the self-insurer's program cost contains more of the losses that are transferred out of the entity through insurance. This is particularly likely if there is little emphasis on loss control. This volatility is more prevalent in a single-entity self-insurance program than in a multiple-entity self-insured pool, wherein the combination of many exposures lessens the variance of risk or volatility of results to all participants.

Depending upon the existence of excess insurance coverage for an entity or pool of entities, and if there is coverage, upon the structure of the excess insurance coverage, post-loss funding may create budgetary difficulties akin to those created by traditional prospective premium determinations.

A Proposed Solution

Bond-Financed Self Insurance. Bond-financed self-insurance programs, whether covering single entity exposures or pooled exposures, are a combination of the traditional concepts of insurance/self-insurance and municipal finance in a nontraditional fashion. To properly analyze such programs, they must be broken down into their two fundamental components, the risk retention structure which may involve varying degrees of risk transfer and retention, and the issuance of municipal bonds or debt instruments in the capital market to provide proceeds for pre-loss funding of expected future losses.

- Statedly alternatively, a public entity (or pool of entities) enters the insurance market as a supplier of insurance capacity by becoming its own insurer, raising the funds for capitalization by issuance of debt. This simplified depiction of the bond-financed self-insurance programs points out the two significant departures from tradition: (1) public entities are not traditionally creators of insurance capacity and (2) insurers traditionally do not use debt in their capitalization structures. However, for the public entity wishing to form an insurance mechanism of some sort, i.e., company, reciprocal or risk retention group, it has no alternative but to capitalize with debt, assuming there is no sufficient surplus of current funds available.

The Self-Insurance Function

General Design. Self-insurance for a public entity or a pool of entities in a bond-financed self-insurance structure is similar to a normal self-insurance program in its design. The significant departure from the traditional approach is the lessening of price and coverage volatility experienced by the entity by the use of excess insurance as protection for the retention funds and the entity. The pool of funds raised by the issuance of the bonds acts both as the capital and surplus of an insurance company and as the excess insurance for the risk retention structure, so that if any losses exceed the planned retentions, on a single occurrence or in the aggregate, pre-loss funds are available to maintain solvency of the retention funds and to pay for those losses, just as an excess policy would replace the deficits and pay the losses in excess of retentions.

Breadth of Coverage. Since there is no real need for excess insurance, the risk retention structure can contemplate any exposure or peril desired without regard

to policy language and underwriting concerns, including consideration of the so-called "uninsurable" exposures.

Expected Loss Retentions. The retention levels are established by historical review of exposures and losses, generally for a minimum of five years. From this review the aggregate expected losses are determined by loss-forecasting techniques. Although a specific loss limitation is not required, as all losses can be forecast without a loss limit being applied and thus fully included in the aggregate expected losses, a specific loss limit can be developed by analysis of the arithmetic means and mode(s) of losses. This feature enhances cost stability as it now sets the maximum impact on the currently funded retentions.

Expected Loss Variance Retention. A further refinement of this retention structure is the addition of another retention fund designed to provide pre-loss funding via current expenditures in a "super-retention" fund that covers the variance of actual specific and aggregate losses from the expected specific and aggregate losses. The only certain (or nearly so) prediction that can be made about actual cash and expected losses is that actual losses either will exceed or be less than predicted. The attainment of actual losses less than expected is desirable in that surplus pre-loss funds can be accumulated for future losses. The reverse scenario, however, can reintroduce program cost instability. By establishing a pre-loss funding in the "super-retention" fund, these excess variances of actual over expected are handled with less likelihood of cost instability, particularly after several years of favorable experience which builds a surplus.

Actual vs. Expected. If actual losses do not exceed total expected losses, the surplus is retained in the retention fund(s) for future periods. This can be continued, provided that luck and accurate predictions hold out, as long as the entity and its risk management advisors deem proper and prudent. Any excess accumulation can be used for reduction of future contributions into the expected loss funds, as contributions into the bond fund, or returned to the general revenues of the entity or entities as a distribution of excess contributions and profit.

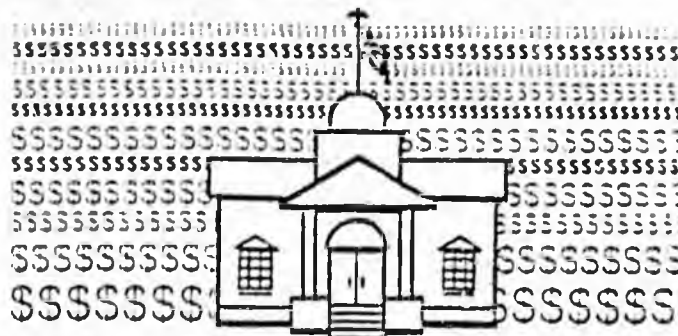
If total actual losses exceed expected losses, the deficit is provided by the bond fund resources, at which time the funds are transferred into the retention accounts, to be held and invested until needed as a payout. Since the bond funds are already in place and a repayment of the debt is structured at the time the bonds are issued, there is no program cost instability arising out of adverse

losses. The bond fund can be protected by insurance or reinsurance, if there is a reasonable and stable market offering coverage at attractive rates, so adverse losses might be covered by insurance. Without any insurance, adverse loss depletion of the bond fund can be handled by issuance of judgment bonds which serve to spread the adverse financial consequences of the loss over future years, by use of current funds from future periods or be ignored, with the bond fund remaining in a depleted state.

Expense Factors. In a self-insurance program, the traditional excess insurer, if any, is rarely responsible for loss control and frequently takes no part in loss adjustment unless the loss has penetrated the retention. The costs associated with these functions, while included in traditional insurance premiums, are highlighted in a self-insurance plan as they are applied separately and identifiably. Similarly, the general administrative expenses normally included in the premium loadings must be separately recognized. These are not additional costs incurred uniquely by the self-insurance, as they are included in traditional premiums. There is, however, an opportunity to recognize greater efficiency in the use of the self-insurer's properly trained staff or the staff of an outside administrator by comparing the self-insured's costs for these services to those included in the premium. It is not uncommon to attain a 10 percent savings in this area alone, with an improvement in the quality of services by using the entity's staff or a third-party administrator. Taxes, profits, and contingency loadings account for another 7 to 11 percent of premium. These costs are completely avoided if there is no excess insurance and are significantly reduced in dollar amounts when incurred in the premiums for excess coverage. Measured as a percentage of total program costs, these loadings can be reduced dramatically over traditional insurance program levels.

Coverage Provided. Given the high degree of program control in the hands of the self-insured entity, coverage can be as broad as the entity wishes, including coverage for the traditionally uninsurable perils. If there is excess coverage in place stipulating certain exclusions, limitations or restrictions, and therefore restraining what can be paid from the expected loss funds and applied against the retentions, a second expected loss "slush" fund can be established outside the protected self-insurance structure, but within the bond financed catastrophe structure to address those carved-out areas of exposures.

Coverages Not Provided. In the absence of specific statutory prohibitions, all lines of coverage and all types of



coverage can be included in the self-insurance program. This includes the routine property and casualty exposures as well as the more exotic (and frequently troublesome) types of liability exposures peculiar to public entities, such as school board liability, corporal punishment, sexual abuse, public officials' errors and omissions, police professional liability, medical malpractice and nursing home liability, environmental impairment, and so on.

There are three areas of exposure requiring special attention. The first two items should not be included in a self-insurance program. Since surety is not insurance, but is essentially a credit relationship, surety bonds should be placed in the conventional insurance market. Since boiler and machinery exposures require a highly specialized type of loss control, those exposures should be left to the traditional providers of boiler and machinery coverage. In both instances there is and has been a ready and reasonably stable market for traditional coverage with respect to both price and coverage availability.

Because of the catastrophic nature of property losses and the unpredictability of severity, particularly that arising out of storms and the possibility of widespread damages being incurred, either to a single entity or to members of a pool, property losses in excess of a selected property loss limit (\$100,000 to \$500,000, depending upon the size of the total expected loss fund) should be insured with an excess property cover. There is a ready and reasonably priced market for such coverage; therefore, this transfer of risk out of the self-insurance program is a prudent decision which serves to protect the loss funds from a catastrophic loss.

Coverage Form. A self-insurance program is designed to pay for the expected losses that occur in the normal course of events, commonly called the working or burning layer. The difference between an occurrence-triggered form and a claims-triggered form is less meaningful in these programs, as ultimately all of the loss dollars come out of the same revenue source without any transfer or sharing of the loss with outsiders. Since there is no transfer or sharing, there is little need to assign potential outflows of funds to specific periods or entities. Further, the distinction between the formats is less critical as there are fewer "long-tail" exposures for public entities, with most losses incurred on property and workers' compensation exposures.

In the event of an occurrence, a reserve is established against the expected loss fund, and if needed, against the catastrophe fund. The catastrophe funds, which are being held in a yield-restricted investment

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account (due to tax implications to be discussed in the section on bond finance), are then transferred to the loss fund account at the time a payout is necessary.

"Docking the Lamb" or Entry and Exit from the Program. In animal husbandry parlance, "docking the lamb" refers to the practice of cutting the lamb's naturally long tail to the familiar short stub for purposes of ovine hygiene. Similarly, the self-insurance program allows for "docking the tail" of current claims-made programs when the exposures are transferred into the bond-financed self-insurance program. Depending upon jurisdictional differences in statutes of limitations and the premium for electing to purchase insurer-offered "tail" coverage, unfavorable or "unhygienic" "long-tail" exposures can be included in the self-insurance program with a prior-acts inclusion endorsement at an appropriate contribution to the expected loss fund.

Should a pooled entity wish to transfer out of the bond-financed program, there is no prior-acts difficulty, as the program is an occurrence-triggered coverage format. To protect the various funds' solvency, the joint underwriting agreements required in all self-insurance poolings obligate the entity to the pool's loss funds for a specified period of years and the bond issue obligates the withdrawing entity to the maturity or call date of the bond, so the pool is adequately protected financially in the event of a withdrawal.

Limits of Liability. In general, limits of liability can be written for virtually any amount deemed proper and necessary by the entity or pool of entities. Since all exposures are covered by several types of pre-loss funding, the pre-loss funds can be structured in layers stacked

high enough to satisfy the post-loss financial objectives of the self-insuring entity. In terms of limits, the bulk of the protection is provided by the bond-generated catastrophe loss fund, so the only constraint on limits is the financial strength and willingness of the entity or pool of entities to take on the debt obligation. If conventional insurance is made part of the structure, the insurer's "leased" capital is added to the funds available to pay losses, thus serving to further increase the limits of liability afforded. If there is not any traditional insurance at the lower levels of funding, there are not any insurer-imposed limits or sublimits of liability over specific exposures.

Municipal Finance Functions

Overview. The traditional use of funds raised by entities in the capital markets is for public works projects, such as roads, schools, hospitals, water and sewage treatment, buildings, parks, and the like. Providing a systematic method of protecting these facilities from direct damage as well as the entity's responsibility for injury to employees and the general public, and thereby facilitating and enhancing the quality and quantity of governmental services, is an equally important public use of funds.

The significant contribution municipal finance brings to the public risk management table is the capability of adequate pre-loss funding of losses in excess of expected losses, the area of traditional coverage assumed by umbrella policies, excess liability policies and reinsurance, without subjecting the entity to the capriciousness of the insurance marketplace. It is not to say that this layer of the risk retention structure is without cost of premium. In fact, the cost of effecting excess coverage via bonds can be more costly than traditional coverage as the debt service on the bond issue will be viewed as the cost of the protection. Such "cost," however, is not spent in the same manner premium dollars are spent, that is, leaving the entity for another permanently, but instead is an acquisition of equity in an insurance entity. Through the repayment of principal from tax revenues, or new money, the obligation is repaid while leaving the bond funds which provide the catastrophe protection intact. It is no different a process from buying a refinance, wherein the principal amount of the loan is repaid over time, increasing the borrower's equity and decreasing the lender's equity.

Public Finance Issues. There are several issues that must be addressed in the structuring of a plan of finance

intended to support a self-insurance program, some of which are common to most public finance deals, and some of which are unusual or unique to self-insurance programs.

Enabling Legislation. In most jurisdictions, the powers and activities of a public entity are restricted by legislation. Therefore, in order to obtain a favorable opinion by bond counsel for the official statement, the document detailing that specific features of the debt offering for the potential lenders, there must be a legal purpose for the bond issuance, which necessitates some type of enabling legislation that permits the entity to borrow money for public purposes, and that includes the establishment of a public risk management program as such a public purpose.

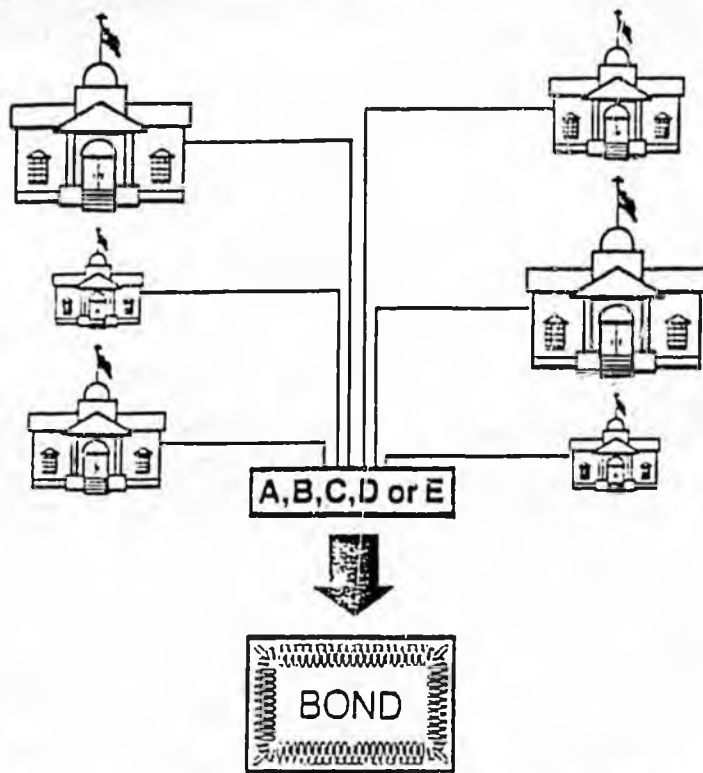
Typically, enabling legislation takes three forms: federal legislation; state-legislated intergovernmental cooperation statutes; and specific legislatively-intended statutes.

Federal legislation, such as the Risk Retention Act, is perhaps the most troublesome from the standpoint of bond counsel, as there is no clear legal opinion on whether or not local and state governments are included in the Act. Because of the broad nature of federal legislation, individual state and local legal issues may remain. In addition, the problem of workers' compensation coverage remains, as the Risk Retention Act clearly excludes this line of coverage. Lastly, the Risk Retention Act allows for establishment of purchasing groups, a practice permitted and used through existing intergovernmental cooperation statutes, as well as the establishment of insurance entities, but does not detail how public entities can raise the capital for forming the insurance entity, and does not address the public purpose issue.

Intergovernmental cooperation statutes are relatively common, but have not been used extensively for addressing risk management activity. The usual cooperative effort deals with purchase of durable goods and consumable supplies, with economies of scale being the motivating factor rather than the procurement of goods and services not otherwise readily available.

While joint purchasing is made possible under the statutes, the insurance industry continues to individually underwrite multiple participants, and current rating programs offer little in the way of economies of scale except for the premium discount factors in workers' compensation plans. The weakness of the cooperation statutes is that there is no clearly identified mechanism for creating insurance capacity, but only the mechanism to collectively purchase goods and services. This weakness leaves the collectivized entities subject to insurance cycles and the inherent instabilities of the insurance marketplace.

Specific legislation retains the collectivization feature



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of the intergovernmental cooperation statutes while specifically stating the legislative intent that entities can finance their liabilities by issuance of public debt,

The Issuing Entity. In the case of a single-entity program, the proposed self-insurer is the issuer of the bonds. Typically this would be a large entity, large enough in terms of exposures and losses to justify a retention program without bond financing. If there is a joint self-insurance plan or pooling program (the distinction between the two being a matter of the number of participants, ranging from several to many), the issue of debt can be accomplished in several fashions:

- a. A legislative authority is formed with taxation powers, by legislative action, and all participants subscribe to an equitable portion of the debt through certificates of participation, commonly called CO's. This

has the advantage of allowing a variety of public entities with varying abilities to raise funds in the capital market to participate.

- b. Each entity raises its own share of the bond fund and is responsible only for its own obligations. This is fair with respect to the differing investment ratings of the entities, and their corresponding interest costs, but is more costly with respect to cost of issuance and is more difficult to coordinate.
- c. Entities, in the absence of legislated authorities, may create a new entity pursuant to pooling statutes or intergovernmental cooperation statutes for the purchase of issuing bonds. The intergovernmental cooperation statutes must allow members to delegate this power to the cooperative entity.
- d. State bond bank statutes, if existent, may permit entities to pool their underlying obligations to be offered to the public. The typical method used in this approach is for the bond bank to buy the obligations, using funds raised from the general public. This facilitates issues of small or unrated entities by providing a ready market for the obligation. A variation of this is the use of a large commercial bank who will buy these pooled obligations, generally on a direct placement basis, using the reserve of its customers as the source of funds, with the intent of making the pooled obligations part of its investment portfolio.
- e. One entity can act as the sole issuer, or as a local bond bank with other entities participating by subscription to the obligation via intergovernmental agreements. This has the advantage of minimizing the cost of the debt issuance. Also the debt service is lower, as the lead entity should have a very favorable investment rating and a correspondingly lower rate of interest on the bonds.

Maturity and Repayment Terms. Maturity is not generally restricted in the enabling legislation, but the terms of the intergovernmental agreements are time-limited, which suggests the terms of the bond issues should correspond to the initial period of the intergovernmental agreements, typically ten to twelve years. This has the effect of spreading the cost of the debt service over a long enough time to make the annual debt service "cost" palatable and provide program cost stability.

Repayment of the debt can be accomplished in four ways:

- a. A serial retirement of the debt, whereby the entire debt is repaid over the life of the issue, generally in a series of equal payments.

- b. A rollover of the entire debt at maturity, with no repayment of principal, such as the Federal debt approach, with the entire bond fund being refinanced every ten to twelve years.
- c. A partial serial repayment with a balloon payment at the maturity, which is rolled over and refinanced.
- d. A sinking fund in which repayments are accumulated and the debt is retired with this accumulation at maturity.

Economics of Repayment. The economics of the repayment structure are such that the greatest investment earnings for the bond fund are earned when the debt is systematically retired, as the interest payment to the lenders is based upon the debt outstanding, an amount that serially decreases, yet the repayment of principal from resources outside the bond fund permits investment of the full corpus of the bond fund to the extent no catastrophic losses have been paid from the fund, with the result being an ever-increasing amount of investment earnings accruing to the fund. At the other extreme, no annual repayment of principal maintains a maximum level of interest to be paid, with fewer opportunities for investment profits due to tax implications to be discussed later.

The typical debt service of a bond issue is an increasing amount of principal repayments which reduces the amount of outstanding liability and causes a decreasing amount of interest payments, as the interest due is based upon the amount of debt outstanding. The sum of the principal and interest repayments is relatively flat over the life of the issue. This level debt service payment provides that means of stabilizing the cost of the protection facility to the participants of the self-insurance plan, and in fact allows for the generation of significant net investment income. Since the full bond fund is available for investment, it earns more in interest than the outstanding debt costs, even at an interest rate equal to the coupon rate on the bond issue.

This accumulation of wealth can be put to several uses, depending upon the enabling legislation. The net investment income can be accumulated as capital to support higher limits of coverage. The earnings can be transferred to the operating account to lower current contributions to the loss fund or to enhance the size of the expected loss fund so as to contain, in the primary layer, larger aggregates or per occurrence losses. The profits can be returned as dividends or be used to repay the principal.

Constitutional and Statutory Debt Limitations. The efficacy of bond-financed self-insurance programs depends

upon constitutional and statutory debt limitations; it is not the power to issue debt, but the ability to secure that debt with revenues over the intended life of the issue. The ability to enter into long-term contracts depends upon constitutional and statutory prohibitions against the issuance of debt without a referendum, issuance of debt without specific current appropriations, or a percentage limitation under which the debt must fall. In spite of this typical constitutional or statutory language, most states permit funding of long-term service contracts with debt.

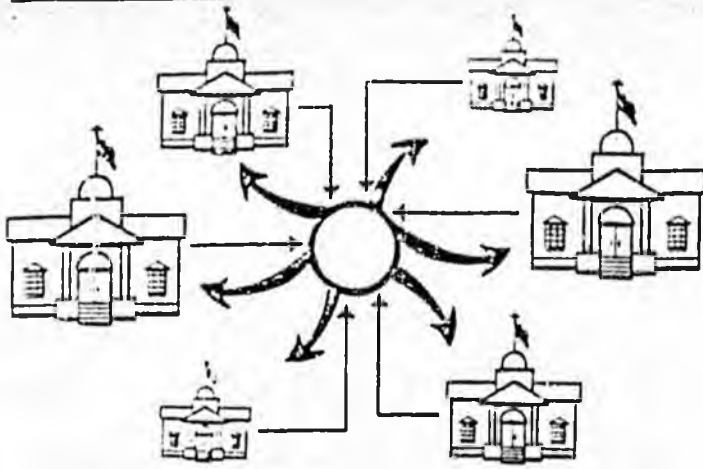
Therefore, in jurisdictions with rigid debt restrictions, each contract and agreement must be questioned with respect to validity and enforceability to avoid non-appropriation problems and direct violation of specific restrictions.

Some jurisdictions have recognized these difficulties and have passed specific statutes, where permitted by state constitutions, that offer a nearly free hand for issuance of debt intended to pay for insurance or insurance-like programs. For example, Illinois law allows for issuance of general obligations public debt for the purpose of funding liabilities, both present and future, without referendum and without being charged against the statutory debt ceiling. The only limiting force on Illinois public entities is the rating services and capital markets, which may deem an issuing entity to be overextended.

Equitable Treatment of Participants. In any pooling program, there is always a concern expressed by participants for equitable treatment. This may arise due to entities with good experience not wanting to subsidize other entities to their own detriment, large entities not wanting to subsidize small entities or vice versa, small rural entities not wanting to participate in metropolitan area loss problems, or any number of similar parochial concerns, which, if not addressed, may be of sufficient concern to prevent the establishment of the pool.

Variances in Loss Experience. Provisions in the intergovernmental agreements can allow for adjustment in the expected loss funds for individual adverse experience. This serves to equalize the exposures among the participants, punishing the adverse experience and protecting the funds of the favorably experiencing entities as well as protecting the security of the bond fund by generating additional expected loss funds.

In keeping with the objective of cost stability and predictability, the adjustments should be limited by either applying loss limits to the actual losses, so as to avoid the full impact of catastrophic losses when forecasting expected losses from actual losses, or to limit, on a



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percentage basis, the adjustment in the contribution to the expected loss fund.

Capitalization of the Insuring Entity. Since participating entities will differ, in varying degrees, in size of exposures and losses, as well as in financial size as measured by the tax base, it is desirable to allocate the share of bonds to be issued for the purpose of providing catastrophic protection for all on an equitable basis.

The allocation of the debt to be issued is based upon some common factor that all participants share that is not inherently unfair, not subject to manipulation by the entity, and easy to determine, verify and understand. This factor may vary by the type of entity, but might be a measure of total tax base, population, school enrollment, miles of highway and roads, or the like.

Investment Ratings and Interest Costs. The interest rate public debt carries is a function of the familiar relationship of risk and return: the greater the risk, the greater the return required by the investor. Investors will either conduct a financial analysis of their prospective borrowers or will rely on the judgment of the analysts of ratings services, such as Moody's or Standard and Poor's. An entity with a high investment rating will receive a rate of interest equal to or close to the market rate of interest as determined by supply and demand in the capital markets.

In the case of a single entity bond-financed self-insurance

program, the interest rate at which the bonds are offered is a function of the entity's investment rating. With multiple participants, however, there may be inequities among the entities arising out of differentials in investment ratings, regardless of whether the bonds are issued by an authority or which the participants assume liability by contract or by one or more entities acting as a "lead" issuer, with non-issuing entities assuming liability by intergovernmental agreements.

As an example, an entity with an A rating may have to offer its debt at fifty basis points (.5 percent) over that of an AAA rated entity. This premium represents what the market feels is necessary to offset the additional risk introduced by the lower rated entity. While familiarity with the rating process is needed to understand this principle, it is not the purpose of this paper to explain the rating process in detail. An excellent and easy-to-read book, *Investing in Municipal Bonds*, by James L. Cooner, is a good resource for a basic understanding of investment ratings.

In the case of an authority acting as the issuer, the rating services or analysts would assign either a rating that is a composite of the individual subscribing entities or the lowest rating of all participating entities, as in the "weak link" theory.

If a composite is used, the "average" rating is translated into an "average" interest rate at which the bonds will be sold, thus rewarding the entities with lower ratings (and higher interest costs) and penalize the entities with higher ratings. If the lowest rating is used, all higher rated entities suffer. Similarly, these inequities arise in the "lead" issuer approach.

This inequity is minimized by use of interest rate penalties and credits provided in the contracts of subscription to the authority or the intergovernmental agreements, in the case of the "lead" issuer approach. In the typical debt repayment scenario, the lower rated entity agrees to pay, to the bond trustee, an amount of interest greater than that required by the bond coupon, and the higher rated entity agrees to pay less, such that the penalty paid by the lower-rated entity offsets the underpayment made by the higher-rated entity. The amount of the credit and penalty is determined by subtracting the bond coupon rate from the rate the entity would expect to have to pay if it were borrowing on its own merits and its own investment rating.

For example, assume there are only two entities participating, one carrying an AA rating and one a BAA rating. The investment banker, in taking the issue to the market, determines that the rate of interest the jointly-issued bonds will carry is 8 percent. In his opinion, the

AA rated entity could issue and sell bonds on its own rating at 7.8 percent, while the BAA rated entity would have to offer bonds with a 40 basis points premium, at 8.2 percent. Each year the bond trustee will make an \$80 payment to the bond holders for each \$1,000 bond outstanding. The AA rated entity will pay to the trustee \$40, the coupon rate for his 50 percent share of the bond, less a \$2 credit for the .2 percent additional cost he bears. The BAA entity will pay his \$40, the coupon rate on his share, plus a \$2 penalty for the .2 percent advantage he gains. The \$38 from the AA entity and the \$42 from the BAA entity pays the combined \$80 interest.

Credit Enhancement. If, in the opinion of the investment banker, credit enhancement is desirable or advisable in order to effectively increase a low investment rating so as to lessen the basis point spread between the particular entity's rate and the "average" rate, the cost of the credit enhancement is borne by that particular entity, as in the absence of the enhancement, the entity would be paying a greater penalty. Any residual differentials between rates would again be subject to penalty/credit adjustments.

In practice, the interest to be paid is not paid directly by the entities, as the investment of the bond fund is sufficient to pay the interest on behalf of the participants. The rating differentials are still effective, as the penalty/credit is computed and applied to the principal repayment amounts instead of the interest amounts.

Security. Closely related to interest rates and credit enhancement is the issue of financial security of the individual entities and their ability to repay their respective indebtedness. The intergovernmental agreements or participation contracts detail the joint and several responsibilities of the participants to each other and to the bond issuer(s). The financial security issue has two elements.



First, repayment of principal and interest is guaranteed by contract or intergovernmental agreement whereby each guarantees its own portion of the debt service as well as the debt service of the others, with the bond principal held on its account acting as collateral to its repayment obligations. If an entity should default, its portion of the bond fund is attached by the other entities who may have to assume the debt service. This gives the nondefaulting entities the option of retiring the current portion of the debt with the defaulting entity's share of the bond fund, in effect, buying the equity or the defaulter's share of the bond fund at a discounted or lesser amount.

The second issue of security deals with maintaining as many funds in the bond fund as there are outstanding debt service principal obligations to the bondholders. Since the corpus of the bond fund effectively collateralizes the debt, any catastrophe penetrations of losses into the bond fund must be replenished. If there is insufficient excess interest earnings accruing to the bond fund, the fund can be restored by an adjustment in principal repayment. This spreads catastrophic losses either over time, if the entity suffering the loss is charged with the entire deficit, or over all participants, if the entities opted to spread the risks among themselves, as in a risk transfer mechanism.

Tax Status of the Issue. Tax status of the issue does not refer to the deductibility of interest expense from taxable income for the borrower, as public entities are protected from taxation by the Constitution of the United States and by state constitutions. The issue of tax status refers, instead, to the inclusion of interest earnings as taxable income for the lenders. Therefore, determination of taxable or tax-exempt status affects the coupon rate the bonds bear, as taxpayers are willing to take a lesser rate of return if the interest income is excluded from their taxable incomes. Since the impact of the Tax Reform Act of 1986 is still not completely understood by the capital markets, there is, in 1987, still market confusion surrounding the spread between taxable and tax-exempt rates of interest, as evidenced by the historically narrow spread of rates during 1986-87. While tax status is only one function of the complex means by which the capital markets determines the market rate of interest, it has a singular impact upon bond-financed self-insurance programs with respect to the investment activities of the pooled or catastrophic funds.

The Arbitrage Issue. Arbitrage is the financial concept of borrowing at a low rate of interest and investing the proceeds immediately at a higher rate of interest. A common type of arbitrage occurred in the early 1980's when life insurance policy loans were made at the contractually guaranteed rates of 4 or 5 percent, and the loans were immediately invested at 9, 10, 12 or more percent. So great is the power of this type of arbitrage that new insurance contract language allowed for higher rates or floating rates for loans, and existing contracts were modified by rider, whereby, in exchange for a higher rate of interest on policy loans, a higher yield on the cash value was guaranteed.

Under current federal income tax laws, arbitrage activity is restricted. The IRS defines arbitrage bonds as


 ... Under current federal
 income tax laws, arbitrage
 activity is restricted...


those obligations of state and local entities which are invested in taxable investments such that the yield on the investment exceeds the yield or coupon rate on the obligation. If the obligations are deemed to be arbitrage bonds, then the interest is taxable to the bondholders, regardless of its previously determined tax-exempt status, and the excess earnings of the arbitrage fund must be rebated to the bondholders to compensate them for losing the tax exemption.

Permitted Arbitrage. Arbitrage is allowed in bond-financed self-insurance programs to a limited degree, currently 10 percent of the outstanding obligation, so that investment costs and the initial expense of issuance of the debt can be covered, leaving the remainder of the proceeds to be invested on a yield-restricted basis. This small degree of arbitrage is sufficient in nearly all cases to pay the administrative costs of running the fund and the initial bond underwriting fees.

Contributions into funds intended to pay losses, i.e., the self-insurance portion of the program can be invested without restrictions on yields as these funds are not bond proceeds, but new monies. There is no problem of commingling funds and creating ambiguity as to the source and use of the funds, as principal payments to retire the debt as the actual dispersion of these monies is accomplished by the bond trustee, typically a commercial bank, while the contributions to pay losses and the dispersion of those funds are made by the insurance administrator.

"Spent" Proceeds. Entities may attempt to conduct arbitrage bond activity without losing the tax-favored status for their bondholders in several ways. The simplest approach is to argue that the original proceeds, once "spent" by the establishment of the catastrophe fund,

are "spent" in the same fashion that conventional insurance premiums are spent, and are no longer proceeds from the borrowing. If that view were accepted by the IRS, the "spent" proceeds held in reserve could be invested freely, without yield restrictions at no adverse financial impact on the bondholders.

Pension Analogy. There are existent revenue rulings which have allowed arbitrage when funding pension obligations, as the bond proceeds were transferred to a third party who assumed contractually all liability for future pension payments. Since there was no further liability of the entity and no possible means by which the entity could directly profit from the arbitrage, the IRS letter ruling was rendered holding the proceeds to be spent, and the bonds were not considered arbitrage bonds.

Captive Analogy. The last method by which entities may seek to avoid arbitrage restrictions is arguing that the proceeds of the bond are spent in the same sense that premium payments are made to a captive insurance company. The IRS applies its rules pertaining to shifting of risk outside the "economic family" and unless the entity can survive the IRS test of captives, the proceeds are not deemed to have been spent and the arbitrage restrictions are not avoided.

Under current IRS rulings, neither the "spent" proceeds argument, pension analogy or captive insurance analogy are accepted as being a valid "spending" of the bond proceeds, and hence, arbitrage is restricted. Further, an attempt to "spend" the bond proceeds by actually paying losses from the bond proceeds and accumulating a sinking fund to retire the bonds or to serially retire the bonds by contributions to the bond trustee will not prevail under IRS scrutiny as the IRS has already made its position clear: as long as any part of the obligation created by the bond issuance is outstanding, the arbitrage rule is in effect.

Arbitrage Resolved. There is one very simple way in which the entire issue of arbitrage bonds and the resultant problems on tax status can be avoided. If the obligations are issued on a taxable basis, there are no arbitrage restrictions. The only constraint to public entity debt being issued on a taxable basis is tradition, as no law or statute requires public debt to be offered on a tax-exempt basis. Currently less than 1 percent of all public debt is taxable, but if the historically narrow spread between taxable yields and tax-exempt yields continues, this volume may well rise.

Regulation of the Pool as an Insurer. Legislation that enables entities to form pools typically does not address the issue of whether or not the insuring entity created is regulated by a department of insurance, unlike the Risk Retention Act, which clearly states such groups or pools are outside the purview of the state regulators. Instead, the insurance statutes will determine whether such entities are regulated, monitored, or ignored. Some jurisdictions allow the regulator to decide whether or not the entities are within the scope of its authority.

Regardless of the actual issue of regulation, bond-financed self-insurance entities are not formally constituted insurers, and, without specific insurance legislation, do not pay premium taxes, participate in residual market mechanisms, or contribute to insolvency funds.

Achieving Stability

By itself, self-insurance does not achieve cost stability; it simply is a method of loss financing. Unless contributions into the loss fund are set at worst-case plus scenario levels, an increase in losses over the pre-funded levels will require an increase in contributions. To paraphrase a current automotive repair advertisement, "You can fund me now or you can fund me later."

Excess insurance over self-insurance programs, in the long run, cannot achieve cost stability. As the insurance marketplace goes through the premium/loss cycle, the excess costs move up and down.

Similarly, loss control activities, an essential part of self-insurance programs, will not achieve stability of costs, as that can lessen the likelihood of some losses, but not prevent all losses.

By itself, a bond fund cannot achieve stability of costs. While the principal and interest are completely predictable, and relatively level over the life of the issue, if losses are paid from the bond funds, there is no assurance that the bond funds will be liquidated "on time." If losses are greater than predicted and funded, the proceeds of the bonds are depleted but the obligations are not repaid. If losses are less than predicted, there are excess bond funds, a tolerable error, but one which suggests the level of costs as represented by debt service was too high.

By establishing a risk management structure consisting of an actuarially sound self-insurance plan supported by an aggressive loss control program and a bond-financed catastrophe fund, stability can be achieved for a long time period. Losses are forecast over an extended time period, such as ten years, and discounted to present

“
...the bond-financed
self-insured public entities
have control over availability,
capacity, definition,
policy language and
the solvency issue...
”

values at an appropriate discount rate. The funds for losses are contributed into the expected loss fund (ELF). A super-retention plan or super-expected loss fund (SELF) is funded with contributions based on a percentage of the ELF. This fund is used to pay the variances of individual annual aggregate losses or individual losses over the primary ELF limit, as well as cover the variance created by differences in the "appropriateness" of the selected discount rate. An administrative fee is added to these contributions. At this point, the program cost is predictable and stable, but only within the actuary's assumed degree of confidence, e.g., "sufficient within the 90th percentile."

This remaining degree of instability is removed not by excess insurance, which, by virtue (or lack thereof) of being insurance, introduces cyclical cost variance, but by the bond fund, which has a predictable and nearly level debt repayment structure determined as of the initial issue date. Should any losses exceed the ELF or SELF as well as any accumulated interest and past-period ELF/SELF surpluses, the deficiencies can be paid with bond funds. Since the earnings on the bond fund are sufficient to pay the interest portion of the debt service as well as part of the principal, these deficiencies are first paid with interest earnings, and then, if necessary, with bond proceeds. Any future surplus in the ELF and SELF go to replenish the bond fund to its full amount.

Should a catastrophe loss occur, even on the first day of the existence of the program, the accumulation of interest on the reserves will serve to offset a part of the ultimate net loss when the case is finally closed several years into the future. If at any time the bond fund is severely depleted, there will be a one-time instability, or adjustment, as the pool issues post-loss judgment bonds. The cost of those bonds is then added to the previously determined costs, and stability is again restored.

There is, of course, the possibility of multiple catastrophe losses occurring within a short time period. While this is a possibility, the relative frequency of casualty losses in excess of \$1,000,000, e.g., exceeding the ELF, and assuming there are no funds available in the SELF, is, in reality, very low. If one assumes the likelihood of a loss in excess of \$1,000,000 is as great as .01 per year, the likelihood of two such losses within one year is .0001, as the probability of the second loss is predicated on the occurrence of the first loss. Expressed as $P(B|A)$, the conditional probability is computed as $P(A) \times P(B)$, or $.01 \times .01 = .0001$. If three such events are feared, the likelihood drops to .000001, expressed as $P(C|B|A)$.

If one assumes the probability of a loss exceeding \$1,000,000 and penetrating the catastrophe fund is .05 during the ten years, the probability of the second loss in the ten year period is .0025. Given the likelihood of such events, the expected value of even a \$5,000,000 penetration (\$6,000,000 ultimate net loss), is only \$262,500, the expected value of the first loss (\$250,000, or \$5,000,000 \times .05) plus the expected value of the second loss (\$12,500, or \$5,000,000 \times .0025).

If one assumes both such losses occur in the same year, the ELF and SELF will probably not contain both losses, so the expected value of the second loss would be slightly higher, as it is the expected value of \$6,000,000, or \$15,000.

Although a probability analysis may be a convenient attempt to assuage concerns with a pseudo-scientific approach, it does not guarantee the hypothesized events will not occur simply because the events are unlikely. In reality, however, public entities insuring exposures conventionally still face similar dilemmas, such as the determination of how high a limit of liability is sufficient, the danger of exceeding aggregate limits on one or more lines of coverage, the problem of facing excluded exposures, and the exposure created by insolvency of the carrier(s) and reinsurer(s).

While there may be no perfect solution, the bond-financed self-insured public entities, by creating their own insuring entity, have control over availability, capacity, definition, and construction of policy language, both pre-loss and post-loss, and the solvency issue. While they cannot completely avoid the uncertainty arising out of the possibility of multiple losses in rapid succession, they do not face the other probabilities of exposures to loss that conventionally insured entities face. Further, if all else fails, they issue post-loss judgment bonds and face the one-time cost adjustment.

Summary

What originally appeared as a crisis turned out to be an opportunity to avoid astronomical cost increases for insurance and begin reducing losses.†

As stated, the purpose of this paper is to explain a means by which the public sector can address its exposures to loss in spite of difficulties in obtaining needed coverage of sufficient limits. Further, it is the purpose of this paper to develop a cost stabilization structure that facilitates the budgeting process of public entities and the correct pricing (i.e., tax levy) of government services.

The structure of a bond-financed self-insurance program, whether for a group of entities or a single entity, accomplishes both goals. The "insurance" capacity or capital raised by the issuance of debt instruments allows public entities to create and control their own insurance programs, thus eliminating the coverage and capacity instabilities inherent in the insurance marketplace.

The use of actuarially sound contributions for expected losses, when coupled with the ability to cover temporary deficits in the loss fund with bond fund proceeds which have a stable "cost," provides a stable, easily budgetable cost factor that can be used in determining appropriate tax levies.

The complicated combination of two traditional disciplines in an innovative manner is not without disadvantages, primarily in the form of long-term commitments of a financial nature. The benefits accruing to a risk management program with stable costs and proper coverage will far outweigh any disadvantages. ■

References

- James J. Cooper, *Investing in Municipal Bonds*, John Wiley & Sons, New York, 1987.
- Public Risk & Insurance Management Association, *Public Risk*, November/December 1986.

AML JIA

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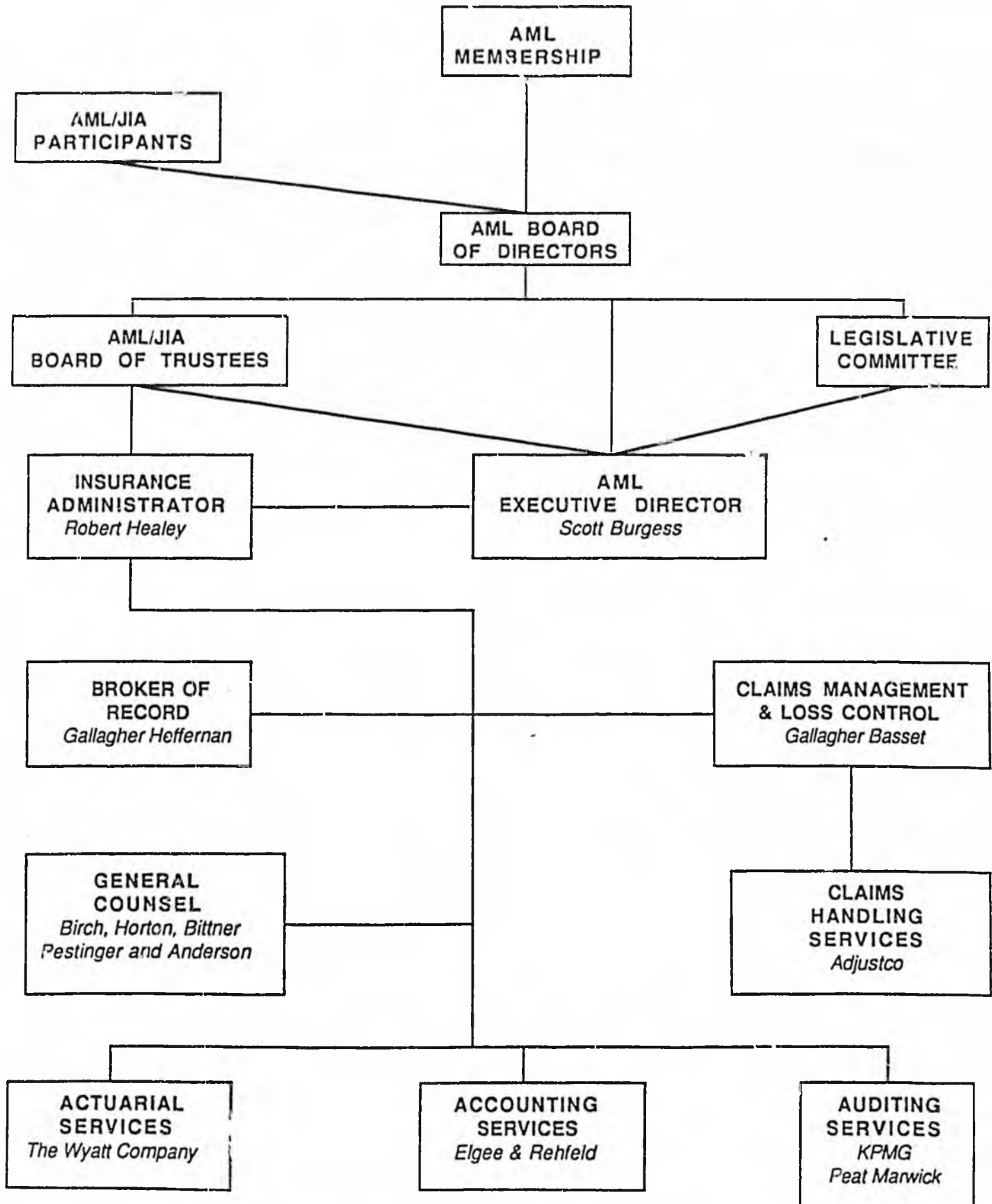
April 12, 1989

AML/JIA ACTIVE PROSPECTS

Aleutians East Borough
Atka
Atkasuk
Brevig Mission
Haines
Houston
Homer
Koyukuk
Hughes
Kake
Ketchikan Gateway Borough
Kenai
Kenai Peninsula Borough
Mat-Su Borough
Napakiak
Newhalen
Northwest Arctic Borough
Nighthuts
Nondalton
Old Harbor
Pelican
Pilot Station
Point Hope
St. Michaels
Shaktoolik
Sitka
Unalaska
Upper Kalskag
Wasilla

ALASKA MUNICIPAL LEAGUE
JOINT INSURANCE ASSOCIATION, INC.

ORGANIZATION CHART



Summary Of Coverages And Limits Of Liability

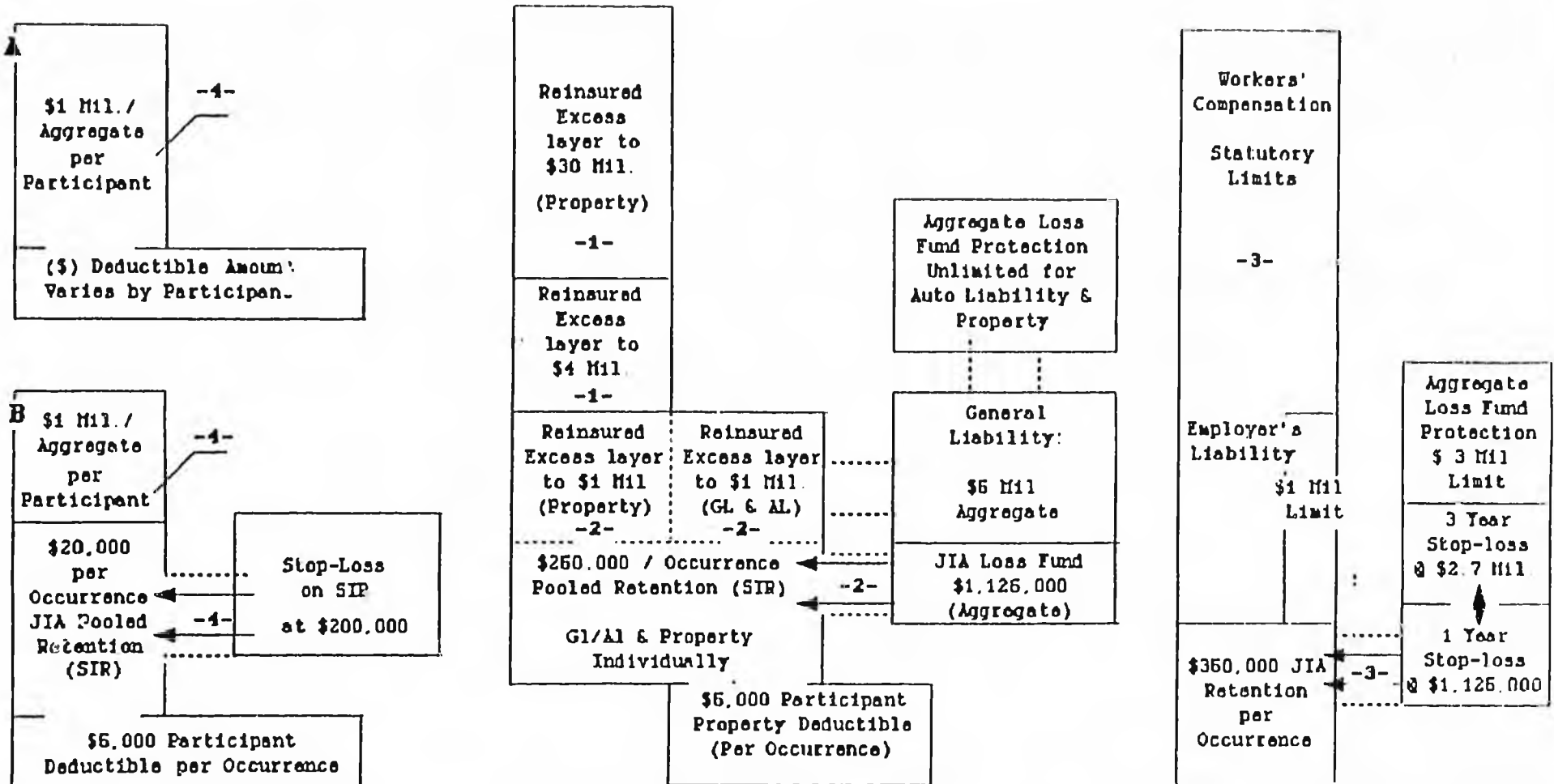
(AID.-JIA)

FY 1989 Structure

**A - PUBLIC OFFICIALS and
B - POLICE PROFESSIONAL
LIABILITY**

**GENERAL & AUTOMOBILE LIABILITY
and PROPERTY**

**WORKERS' COMPENSATION &
EMPLOYER'S LIABILITY**



-1-, -2-, -3-, -4- References Specific To Carriers
(Refer To Section On "Reinsurance & Excess Insurance Coverages" For Detail)

THIRTY THREE & ONE-HALF YEAR STUDY
ALL STOCK PROPERTY/CASUALTY COMPANIES IN U.S.A.

(UNDERWRITING PROFIT/LOSS IN MILLIONS)

Derived from data in: "BEST'S INSURANCE MANAGEMENT REPORTS" of A.M.T. BEST CO.

	PLUS (+)		MINUS (-)		Billions
	\$1-99 Millions	\$1-99 Millions	\$1-99 Millions	\$1-99 Millions	
1953	335				
1954	387				
1955	258				
1956				134	
1957				358	
1958			87		
1959		73			
1960		70			
1961		35			
1962		9			
1963				210	
1964				341	
1965				419	
1966		109			
1967		27			
1968				186	
1969				383	
1970				145	
1971		834			
1972		919			
1973		219			
1974					1,765
1975					2,899
1976					1,399
1977		793			
1978		1,284			
1979					1,000
1980					2,770
1981					4,573
1982					8,440
1983					11,091
1984					19,371
1985					22,567
1986					13,844
1987-1992					3,272
1988					?

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March 24, 1989

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The Honorable Steve Frank
Member, House of Representatives
State of Alaska Legislature
P.O. Box V
Juneau, Alaska 99811

Dear Representative Frank:

I have been asked by the Alaska Municipal League to give you my opinion as to the constitutionality of the proposed draft legislative bill relating to municipal insurance arrangements. This letter will refer to the work draft of that bill dated 02/20/89 with amendments suggested by my letter of February 28, 1989 to Robert Healy.

In my opinion, the draft legislative bill with the changes indicated in my letter of February 28, 1989 would if enacted constitute a valid legislative enactment. Further, in my opinion such a legislative bill if enacted would not be in violation of any provision of the Alaska State Constitution. Specifically, the apprehension that indebtedness might be authorized pursuant to the legislative enactment which would violate the Alaska State Constitution does not make the enactment unconstitutional. We would advise that action be taken pursuant to the legislative authority which is constitutional at the local government level. I suggested that the particular means of authorizing constitutionally permitted indebtedness be specified in the bill if it was deemed to be the only means that was permitted under our Constitution. This suggestion which I had hoped would satisfy the apprehension on the bill did not find favor.

Very truly yours,

Eric E. Wohlforth
Eric E. Wohlforth

EEW:dc

LAW OFFICES
JOHN E. HAVELock
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ANCHORAGE ALASKA 99501

(907) 278-1810

March 24, 1989

Representative Steve Frank
119 N. Cushman, Suite 211
Fairbanks, Alaska 99701
Fax Number 458-3348

Dear Representative Frank,

Alaska's smaller towns and villages need affordable insurance. The only way they can get it is through systems like the nonprofit, Municipal League JIA, creating their own insurance pool arrangement. The pool needs the backing of a capital reserve. I am pleased to hear that you will be a principal backer of legislation allowing the creation of the fund through the Bond Bank.

I have reviewed draft legislation on this subject which is before you. As an attorney formerly specializing in bond work and now devoting much of my time to constitutional law, I believe the proposed legislation is constitutional.

I realize that an attorney with the Attorney Generals Office has voiced concerns on this subject. To a degree, I share his concern. However, the distinction must be made between "facial" constitutionality and constitutionality "in execution".

This distinction might be illustrated better by a bill to allow health officials to conduct searches. On its face, such a bill is not unconstitutional though it signals many constitutional issues. The administrative practices which determine when, how, and by whom such searches are conducted may well be unconstitutional but such issues are not ripe until the plan of execution is established.

There are many issues to be addressed beyond the legislation itself, in determining in how this bond fund should be created and administered. Mr. Wohlforth and other draftsmen of this bill (which is similar to legislation adopted in other jurisdictions on this subject and which have similar constitutional restrictions) have wisely chosen in this draft to leave open specific choices in execution until a more detailed exploration of interrelated marketing and legal strategies is undertaken with this legislation in place.

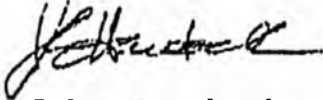
Unlike some other legislations, this statute is neither mandatory nor automatic but requires specific implementation, always under the eye of cautious attorneys. In the extreme

Representative Steve Frank
March 24, 1989
Page 2

counsel require that a test case be brought to test the legality of a particular strategy. Some years ago I represented the taxpayers in such a case on the earthquake mortgage relief bonds, which paved the way for that successful program.

Thus, while there are many constitutional pitfalls to be avoided in execution, the legislation, as now phrased, is not unconstitutional on its face and should not be tabled or otherwise defeated on constitutional grounds. I urge the legislature to adopt the bill so we can get on with the plan.

Sincerely,



John Havelock

cc: Alaska Municipal League
Eric Wolforth

STATE OF ALASKA
THE LEGISLATURE

HOUSE OF REPRESENTATIVES
JUNEAU ALASKA 99801
202 465 1800

LEGISLATIVE AFFAIRS AGENCY

MEMORANDUM

February 15, 1989

SUBJECT: Joint insurance arrangements
(Work Order No. 6-0814)

TO: Senator Steve Frank
Attn: Paul Pesika

FROM: Michael F. Ford *M.F.*
Legislative Counsel

You have asked for our review of legislation to allow municipalities involved in joint insurance arrangements to finance debt through the Alaska Municipal Bond Bank. As explained in this memo, it is our opinion that the legislation would violate Article IX, section 9, of the Alaska Constitution.

Under Article IX, section 9, municipalities are prohibited from contracting debt, unless the debt is authorized by the governing body for capital improvements and ratified by the voters. A "debt" in the context of this constitutional limitation, means an obligation secured by the full faith and credit of the municipality; it does not include an obligation payable from funds on hand or current revenue. 81A C.J.S. §§219,220. The proposed legislation would authorize a contractual pledge of money by a municipality through a joint insurance arrangement. This pledge of money is the type of "debt" that is prohibited by Article IX, section 9, unless the debt is for a capital improvement and is ratified by the voters. The use of notes, certificates of participation, or bonds to establish insurance reserves would clearly not constitute a "capital improvement." See City of Juneau v. Hixson, 373 P.2d 743 (Alaska 1962).

Under Sec. 21.76.120(c) of the proposed legislation, the debt incurred would "not be a general obligation of a municipality." This language is clearly an attempt to avoid the prohibition against debt contained in Article IX, section 9. I do not think that this language will effectly remove the constitutional problem. If a court considered this issue,

Senator Steve Frank
Page 2
February 15, 1989

it would certainly look at the substance of the pledge. Unless the pledge is limited to current revenues, the pledge amounts to creation of a prohibited obligation on future revenues of the municipal treasury. This same section also provides that a pledge may "not include revenues derived from taxes." Again this is an effort to avoid creating the kind of "debt" prohibited by the constitution. However the debt will still be payable from whatever other general revenues are available, probably state funding. So, by eliminating tax revenues in securing the pledge, the state may be faced with an increased "moral obligation" to make payments on these bonds as a practical matter. This is precisely the kind of future obligation that Article IX, section 9 was designed to avoid.

I should also mention that there is an exception to Article IX, section 9, contained in Article IX, section 11. But this exception does not apply to the suggested legislation as I interpret it. The only bonds mentioned in this proposal are those issued by the Alaska Municipal Bond Bank. The exception would not apply to debt undertaken by a municipality to repay revenue bonds issued by the Alaska Municipal Bond Bank.

For the above reasons, it is our opinion that a municipality could not finance its joint insurance arrangement in this manner, without serious risk of violating the state constitution. Because bond financing is a specialized area of the law it would be wise to have bond counsel review this proposal before introducing legislation on the subject. This kind of financing arrangement may also create marketing or other practical bonding problems that bond counsel could provide advice on.

MFF:kb
WKK2/007

STATE OF ALASKA

DEPARTMENT OF LAW

OFFICE OF THE ATTORNEY GENERAL

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PHONE: (907) 465-3600

January 31, 1989

Hon. Ronald L. Larson
Alaska State Legislature
P.O. Box V
Juneau, AK 99811

Re: Debt financing for municipal
joint insurance pool

Dear Representative Larson:

At the request of Jay Hogan of your staff, I have reviewed a memorandum dated February 12, 1988 of the Alaska Municipal League relating to "debt financing for municipal liability exposures." I have also reviewed a draft bill dated January 24, 1989 attached to the memorandum. You ask our opinion whether it would be lawful under art. IX of the Alaska Constitution for an association of municipalities to finance an insurance pool through the issuance of revenue bonds. I believe that it is possible to finance an insurance enterprise through the issuance of revenue bonds. Of course, my opinion is conditioned on the financial feasibility of the enterprise and possible federal tax consequences which would affect the marketability of the bonds.

It must be made clear at the outset that we are not giving an opinion concerning the adequacy of the draft bill to accomplish the purpose of the municipal league. We believe that providing insurance coverage for municipal activities is a public purpose for which municipal funds may be expended. Under art. IX, sec. 11 of the Alaska Constitution, the prohibition against incurring debt does not apply to a public enterprise financed solely by revenues generated by the enterprise. The provision of insurance to an association of municipalities probably qualifies as an enterprise under sec. 11. Presently, the municipalities are presumably purchasing insurance from private carriers and we all know that they are not charitable institutions. Insurance premiums paid by municipalities would serve as the source of rev-

Hon. Ronald L. Larson
Alaska State Legislature
Re: Debt financing, municipal joint ins.

January 31, 1989
Page #2

enue to support the issuance of revenue bonds. These periodic premiums could be pledged by the public corporation operating the insurance enterprise to secure the repayment of the bonds.

Subject to authorization being granted by law, the Municipal Bond Bank Authority could operate the enterprise or it could be authorized to spin off a subsidiary public corporation for this purpose. It is also possible for municipalities to form an entity by cooperative agreement to jointly exercise the implied power to insure against risks without using the Municipal Bond Bank Authority. See Alaska Const. art. X, sec. 13 and AS 36.30.700 -- 36.30.790. However, it may be desirable to use the authority as the conduit for the financing because it is recognized by potential investors and, by virtue of that recognition, enjoys a favorable bond rating. Section 13 also allows cooperative agreements between municipalities and state agencies.

I have reviewed the memorandum dated January 30 prepared by legislative counsel on this matter and must respectfully disagree with his conclusions. Legislative counsel argues that a municipality would be barred from this financing technique because the municipality is not financing capital improvements. In support of his conclusion, counsel cites City of Juneau v. Hixson, 373 P.2d 743 (Alaska 1962). This financing arrangement could be distinguished from the method used in Hixson if the premiums paid by the municipalities are subject to annual appropriation. For this financing to work, there would need to be agreements between each municipality and the financing entity in which the payment of premiums is conditioned on the adoption of municipal appropriations. It is also likely that each municipality would need to acknowledge a moral obligation to make premium payments until the bonded indebtedness is retired. Because the debt incurred under this proposal is not for capital improvements, a municipality cannot unconditionally pledge general tax revenues. However, we believe there is no problem making premium payments from tax revenues generated by a municipality if, as explained above, the governing body of the municipality retains the discretion to appropriate amounts to pay the premiums.

I agree with legislative counsel that the committee should seek the advice of a qualified bond counsel before this bill is prepared for introduction. For example, without the concurrence of bond counsel, I would be hesitant to recommend that the bill allow the issuing entity to use negotiable or nonnegotiable instruments or certificates of participation.

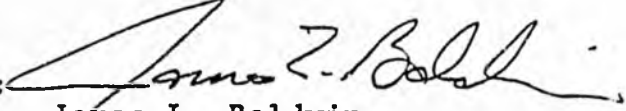
Hon. Ronald L. Larson
Alaska State Legislature
Re: Debt financing, municipal joint ins.

January 31, 1989
Page #3

I hope this memorandum will serve your purposes.

Sincerely yours,

GRACE BERG SCHAIBLE
ATTORNEY GENERAL

By: 
James L. Baldwin
Assistant Attorney General

JLB/pjg

cc: Michael Ford
Legislative Affairs Agency

Arthur H. Pecerson
Department of Law

AML JIA

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FAX: (907) 463-5480

April 12, 1989

The Honorable Steve Frank
Alaska State Senate
State of Alaska
P. O. Box V
Juneau, Alaska 99811-3100

Re: AN ACT RELATING TO MUNICIPAL FINANCING
 AND MUNICIPAL JOINT INSURANCE ARRANGEMENTS,
 THE ALASKA MUNICIPAL BANK

Dear Senator Frank:

In 1986 the Alaska Legislature, under AS 21.76, gave Alaskan municipalities, city and school borough school districts authority to form joint insurance arrangements as an alternative to commercial property, liability and workers compensation insurances. This legislation was enacted to enable municipalities to cope with the adverse effects of constantly fluctuating insurance markets. Availability and cost of needed insurance coverages has been subject to wild swings which place a strain on the municipal budgeting process. These wild swings are best illustrated by the enclosed study published recently by the Insurance Services offices. These severe swings in profitability have caused large rate increases and restrictions of coverage for municipalities countrywide.

In recent years, many states including, California, New York, Texas, Louisiana, Arkansas, Michigan, Washington, Maryland, South Dakota, Montana, Kentucky and Illinois have passed enabling legislation allowing their public entities, municipalities, school districts, special districts, etc, to use alternative methods of financing the costs of their insurance risks. Such capital market financing methods as Bonds, Certificates of Participation and Letters of Credit, are now being used to augment, supplement, or replace commercial insurance. These alternative financing methods are also being used in private industry. Self insurance, risk retention groups and risk purchase groups are indications of the continuing trend towards alternative approaches to insurance in the financing of risk (costs of loss). It is estimated that by 1990, 35 to 40 per cent of commercial organizations, both public and private, will be using such alternative risk finance techniques. In the public sector there are currently over 200 public pools such as ours. In addition, most major cities, counties and states are

self insured to some extent.

The purpose of this Act, then, is to allow municipalities and municipal joint insurance arrangements organized under AS 21.76 to utilize such alternative methods to finance the costs of establishing self funded reserves to cover their liabilities. Such funds would be used:

- * to create capital surplus on a pre-loss basis to fund to aggregate retention levels for multiple losses requiring payments in excess of retention level.
- * to fund large losses in excess of aggregate retentions on a post loss basis in lieu of assessments.
- * to augment, supplement or replace reinsurance or excess insurance.

The amount of funds needed to accomplish these goals would be determined by actuaries certified by the American Academy of Actuaries. The Alaska Bond Bank or other lender would have right of approval. They could either accept or reject our proposal based on their underwriting criteria.

Currently, the AML Joint Insurance Association self funds the first \$250,000 of its Property and Liability losses. The first \$350,000 of Workers Compensation loss is also self funded. This self funding is accomplished on a pooled basis using a portion of the member's premium contributions. This pooled loss fund is actuarially determined by certified actuaries, and along with reinsurance and administrative costs is reflected in the rates charged our members. Our reinsurance includes both an occurrence limit and aggregate retention limits as required by AS 21.76.

The requested legislation would provide us with a "tool" to use in better managing the financing of our risks. It could be used to reduce or replace reinsurance when its cost is expensive and to supplement our program with coverages not offered by commercial insurers. The fund could also be used to provide coverages for our members at more favorable costs than is now provided by insurers. Municipalities in other states have used this approach to provide necessary funds at substantially less cost than those of insurers when the market is "hard." The cost of insurance premiums can be likened to the cost of debt service on a capital instrument. If the cost of debt service is less than the cost of conventional insurance then certainly debt financing serves a legitimate public purpose. Financing of its costs of risk also gives municipalities greater control of their own destinies. These alternative financing arrangements would give us flexibility and clout when dealing with insurers. Flexibility in that we would purchase

Honorable Steve Frank
April 12, 1989


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reinsurance in greater amounts when prices and coverage are The inexpensive, and lesser amounts when prices increase and coverage decreases. The clout comes from reinsurers knowing that we have an alternative to purchasing our coverage from them.

In summary, the requested legislation would give Alaskan municipalities and the AML Joint Insurance Association greater protection against the cyclical swings of the insurance industry. It would enable us to increase our financial strength while broadening our coverages and would give us a stronger bargaining position with reinsurers.

Your support is earnestly requested and will be deeply appreciated.

Sincerely,


Robert F. Healey, CPCU, ARM, ALCM
Administrator

Enclosure

Copies to: Phil Younker, Chairman, Board of Trustees, AML/JIA
Members, Board of Trustees, AML/JIA

CURRENT PARTICIPATING MEMBERS OF THE AML/JIA

PARTICIPANTS	AUTHORIZED REPRESENTATIVES	RISK MANAGERS
Akutan	Jacob Stephin, Mayor	Erika Tritremmel, Administrator
Angoon	Cynthia Paul, City Clerk	Cynthia Paul, City Clerk
Barrow	Eben Hopson, Jr., Mayor	Eben Hopson, Jr., Mayor
Chuathbaluk	Terry Hoefflerle, City Manager	Terry Hoefflerle, City Manager
Cordova	Jack Ferrence, Finance Director	Jack Ferrence, Finance Director
Craig	Dave Palmer, Administrator	Dave Palmer, Administrator
Dillingham	Lyle Larson, City Manager	Lyle Larson, City Manager
Eagle	Jean Boone, City Clerk/Treasurer	Oscar Ingold
Elim	Luther Nagaruk, City Clerk	Luther Nagaruk, City Clerk
Emmonak	John Alder, City Manager	John Alder, City Manager
Golovin	Thomas Punguk, Mayor	Thomas Punguk, Mayor
Hooper Bay	Susie DeGrace, Administrative Assistant	Susie DeGrace
Huslia	Elsie Vent, Administrator	Elsie Vent, Administrator
King Cove	Wayne Marshall, City Manager	Wayne Marshall, City Manager
Kotlik	Peter F. Elachik, Sr.	Peter F. Elachik, Sr.
Kotzebue	Allen Jessup, Finance Director	Allen Jessup, Finance Director
Mountain Village	Joyce A. Brown, City Clerk	Robert H. Hall, VPSO
Nenana	Steve Bainbridge, City Manager	Steve Bainbridge, City Manager
Nikolai	Roger Jenkins, City Manager	Roger Jenkins, City Manager
Nome	Polly Prchal, City Manager	Polly Prchal, City Manager
Nunapituk	Eli J. Wassillie, Administrator	Eli J. Wassillie, Administrator
Ouzinkie	Debra Garner, City Clerk	Debra Garner, City Clerk
Palmer	David L. Soulak, City Manager	David L. Soulak, City Manager
Petersburg	Patricia Curtiss, Acting City Manager	Patricia Curtiss, City Clerk
Port Lions	David Wakefield, City Clerk	David Wakefield, City Clerk
Quinhagak	Larry Strunk, Administrator	Larry Strunk, Administrator
St. Mary's	Francis Thompson, Administrator	Francis Thompson, Administrator
Sand Point	Bob Juettner, Administrator	Bob Juettner, Administrator
Seward	Max Royle, City Manager	Max Royle, City Manager
Shishmaref	Morris Klyutelluk, Administrator	Morris Klyutelluk, Administrator
Skagway	Tom Healy, City Manager	Tom Healy, City Manager
Soldotna	Richard Underkoller, City Manager	Richard Underkoller, City Manager
Tenakee Springs	Janice Eagle, City Clerk	Janice Eagle, City Clerk
Thorne Bay	Ruth Anne Taylor	Ruth Anne Taylor
Unalakleet	Steve Kniseley, Administrator	Steve Kniseley, Administrator
Wainwright	Frances Hopson, Mayor	Frances Hopson, Mayor
Whittier	Cecil DePedro, Finance Director	Cecil DePedro, Finance Director

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Alaska State Legislature



Senate

MEMBER
Finance Committee
Resources Committee
Legislative Council
Special Committee on Banking &
Economic Development

VICE-CHAIR
Community & Regional
Affairs Committee

MEMORANDUM

DATE: April 12, 1989

TO:  Senator Al Adams, Chairman
Community and Regional Affairs Committee

FROM: Senator Steve Frank

SUBJECT: SB 268, An Act relating to municipal financing and municipal joint insurance arrangements; the Alaska Municipal Bond Bank Authority; and providing for an effective date.

SB 268, legislation developed and endorsed by the Alaska Municipal League will allow municipalities and municipal joint insurance associations to utilize debt financing to establish reserves to self-insure against liability when the cost of reinsurance is too high.

Recognizing that insurance costs were reaching levels beyond the reach of many individual municipalities, the Fourteenth Legislature passed legislation establishing joint insurance pools. The proposed bill will provide a back-up tool that municipalities and municipal joint insurance associations can use in instances where excessively high premiums predominate in the reinsurance market.

Drafts of the bill were reviewed by Eric Wohlforth, bond counsel for the Alaska Municipal League Joint Insurance Association, and John Havelock. Both attorneys have endorsed the proposed bill and are of the opinion that the proposed legislation, as phrased, is constitutional.

The Alaska Municipal League Joint Insurance Association has offered to have staff available to answer any questions the committee might have regarding provisions of the legislation.