STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
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Justin P. Wilson
Comptroller

May 20, 2013

Honorable A. C. Wharton, Mayor
Members of City Council
City of Memphis
125 North Main RM 368
Memphis, TN 38103-2017

Re: Review of the Refunding Plan for the Proposed General Improvement Refunding Bonds, Series 2013

Dear Mayor Wharton and Memphis City Council Members:

This letter acknowledges receipt of a request on April 9, 2013, to review a plan of refunding (the "Plan") for the proposed issuance by the City of Memphis (the "City") of an amount not to exceed $135,000,000 General Improvement Refunding Bonds, Series 2013 (the "Series 2013 Refunding Bonds").

This Office became aware of issues related to interfund loans and negative fund balances in January of 2013. This Office sent a letter to the City dated February 19, 2013 expressing concern with the negative fund balance in the New Memphis Arena fund. In response to the City's request for review of the Plan, by letter dated April 19, 2013, this Office informed you that a report of the review could not be issued until compliance with Tennessee Code Annotated Title 9, Chapter 21 (the "Act") has been achieved. By mutual agreement we granted you a 30 day extension to respond. The Mayor and representatives of the City met in Nashville with me and representatives of my staff on May 6, 2013 to discuss proposed actions to correct the non-compliance. Non-compliance concerns identified for correction are listed below. The City should conduct a risk assessment to determine if there are other internal control issues which may uncover additional instances of non-compliance.

Based on the proposed actions presented to us by the City on May 6th and subsequently submitted documents and assuming the Council adopts the proposed resolutions and takes action as outlined below, the City will be considered to have submitted all information required of it and to have fully responded to the Comptroller's notification of non-compliance. The Grant Anticipation Notes as attached to this letter are hereby approved. Upon the Council and the City taking the actions set forth below, the City will then be able to enter into a "finance transaction" as defined in Tennessee Code Annotated Section 9-21-151. Included in such definition is the issuance of general obligation debt, including refunding bonds.

As a consequence, and based upon the assumption that the Council and the City will take the actions set forth below, we are now able to release the report of this Office concerning the City's Plan. Note, if for any reason the Council and the City fail to take the actions set forth below on or before May 28, 2013, then the enclosed Report shall be and hereby is rescinded and the City will be placed on the list of public entities failing to respond pursuant to Section 9-21-151 and will be deemed to be in non-conformance of Section 9-21-406. At that time the City will be legally unable to issue the Series 2013 Refunding Bonds or enter into any other finance transaction.

NON-COMPLIANCE ISSUES

- Deficit fund balances (New Memphis Arena, Fleet Management, and Unemployment Compensation)
- Various interfund loans not in compliance with Section 9-21-408 (authorization, approval and documentation, including appropriate actions by City Council)
- Failure to file Reports on Debt Obligation/CT-0253 for interfund loans
- Failure to maintain a balanced budget on a cash basis for each fund
- Failure of Debt Management Policy to require specific legislative authorization for principal deferral

CORRECTIVE ACTIONS

- Proper Issuance of Grant Anticipation Notes (Resolutions and Note Forms attached as Attachment A)
- Amendment of Debt Management Policy
- Amendment of Internal Control Policy and Implementation of Related Procedures
- Amendment of Fiscal Year 2013 Budget
- Accounting entries and fund transfers
- Filing Reports on Debt Obligation/CT-0253 for Grant Anticipation Notes and for the retired New Memphis Arena Capital Outlay Note

PLAN OF REFUNDING

Pursuant to the provisions of the Act, a plan of refunding must be submitted to our Office for review prior to the adoption of a resolution by the governing body of a local government authorizing the issuance of refunding bonds secured, in whole or in part, by the full faith and credit and unlimited taxing power of the local government. The information in your Plan includes representations by the City that may not reflect either the City's current or future financial condition or market conditions currently or at the time of sale. This review is based on the City's representations which we have not verified.

The City intends to sell by negotiation $112,470,000 Series 2013 Refunding Bonds priced at an estimated premium of $22,983,026 in the capital markets to advance refund:

- $18,385,000 of the General Improvement Bonds, Series 2004 (the "Series 2004 Bonds");
- $47,775,000 of the General Improvement Bonds, Series 2006A (the "Series 2006A Bonds"); and
- $52,825,000 of the General Improvement Bonds, Series 2007A (the "Series 2007A Bonds).

Collectively, these are the "Refunded Bonds." The total amount of refunded principal is $118,985,000. The Savings Schedule presented in the Plan's Bond Cash Flows and Statistical Summary indicates the proposed refunding will generate net present value savings of $3,430,955 or 2.88% of the refunded principal amount of bonds totaling $118,985,000.

THE CITY'S PROPOSED REFUNDING OBJECTIVE

The Plan's Executive Summary indicates that the Series 2013 Refunding Bonds are being issued for "budgetary cash flow relief" and to maximize up front savings with minimal or no increase to aggregate debt service. The City's debt is being restructured to provide debt relief in Fiscal Years 2014 to 2024 by shifting debt service for those fiscal years to Fiscal Year 2025.

This series of refunding bonds will be the second of its kind since 2010. Refunding transactions such as these are often referred to as "scoop and toss" transactions since the current principal is scooped or removed from the current year(s) and thrown out to later years. The City's Financial Advisor has provided graphic representations of the impact of these refundings (copies are included as Attachment B).

In its debt management policy (the "Policy") the City states that a goal of the Policy is to assist the City to "[m]aintain appropriate resources and funding capacity for present and future capital needs." Prior to the 2010 refunding, the City's debt service would have declined smoothly over time, thereby making increasing amounts of revenues to be available for future capital projects or operations. The City could have chosen to adhere to this debt service schedule by raising revenues, reducing services or reducing expenditures to a sustainable level sufficient to cover the current debt service. Instead, by delaying the payment of principal, the City has chosen to shift the tax burden from current taxpayers to future generations. In order to avoid further financial stress, after the issuance of the Series 2013 Refunding Bonds, the City's use of "scoop and toss" refundings should be discontinued and a clear solution to the City's excess expenditures exceeding available revenues should be implemented.

COMPLIANCE WITH THE CITY'S DEBT MANAGEMENT POLICY

The City provided a copy of its Policy. When the City submits Form CT-0253 within 45 days of issuance of the Series 2013 Refunding Bonds, the City must describe, in specifics, how its debt issue complies with its Policy.

The State Funding Board has set as a minimum requirement that a debt management policy must require clear disclosure of the terms and life of each debt issue, including principal and interest payments. This disclosure must include a debt service schedule outlining the rate of retirement for the principal amount. If the policy permits deferral of payment on principal or backloading, the policy must require the City Council to provide specific justification for each deferral— it may not, however, permit blanket approval. It is noted that the City's Policy does not currently meet this minimum requirement regarding backloading. It also does not reflect use of interfund borrowings or the requirement to file the Report on Debt Obligation/CT-0253 with the City Council. The City has agreed to review and amend the Policy.

INTERNAL CONTROL CONCERNS

Local governments must have adequate internal controls to safeguard against and to detect promptly expenditures in excess of funds available. The City described in its communication internal control deficiencies related to budgetary controls and its pooled checking account. Without these safeguards, interfund loans to cover deficits were improperly made. . It should be noted that the City's strong financial reporting included the information by which we discovered the existence of weaknesses in internal controls related to budgetary compliance and other instances of noncompliance related to debt obligations.

The City needs to address these weaknesses to comply with the balanced budget requirements of the Tennessee Constitution, State law, and its own Charter. The City is directed to address the identified internal control deficiencies to prevent future budgetary noncompliance, nonconforming obligations, and non-reporting of debt. Addressing these areas should reduce or prevent future instances of noncompliance. See Attachment C for a listing of weaknesses and directives.

FISCAL CONCERNS

Governments issuing notes under the Act must maintain their fiscal affairs on a cash basis and current receipts must be sufficient to meet current expenditures. This Office strongly encourages the Council to look at the fiscal needs of the community, including those that have been less visible due to the interfund borrowings. We are concerned with the low level of general fund balance after accomplishing the corrective actions listed above. The City appears to have funding needs in the near future for liabilities related to pension obligations, other post-employment benefit obligations, and money owed to the school system. Also, the City has aggressively used PILOTs and other property tax incentives for economic development purposes which have cut into future property tax revenue growth.

In this reappraisal year with a decrease in property values, the Council will have to increase the tax rate to the level of the certified tax rate just to achieve tax neutrality with the same amount of revenues as the current fiscal year. Pursuant to Tennessee Code Annotated Section 9-21-403 as long as notes issued under the Act are outstanding, the City must submit its budget for approval by the Comptroller who is to determine whether or not the budget will be in balance in accordance with the Act. If the budget does not comply with the Act, then the Comptroller has the power and the authority to direct Council as the governing body of the City to adjust its estimates or to make additional tax levies sufficient to comply with the Act.

REPORT OF THE REVIEW OF THE PLAN OF REFUNDING

Enclosed is the report of the review of the plan of refunding required by Tennessee Code Annotated Section 9-21-903. This letter and this report including the Plan are to be placed on the City's website prior to the meeting of the City Council adopting the refunding bond resolution and to be reviewed at that meeting.

The enclosed report does not constitute approval or disapproval for the proposed Plan or a determination that a refunding is advantageous or necessary nor that any of the outstanding obligations should be called for redemption on the first or any subsequent available redemption date or remain outstanding until their respective dates of maturity. THE ENCLOSED REPORT ASSUMES THAT THE CITY WILL ACCOMPLISH THE CORRECTIVE ACTION AND BECOME COMPLIANT WITH THE ACT PRIOR TO THE ISSUANCE OF THE SERIES 2013 REFUNDING BONDS.

This letter and the enclosed report do not address the compliance with federal tax regulations and are not to be relied upon for that purpose. The City should discuss these issues with a bond counsel or tax attorney.
Each report is effective for a period of one hundred and twenty (120) days. If the refunding has not been completed during this time, a supplemental plan of refunding must be submitted to this Office, at that time we will issue a report thereon pursuant to the statutes. In lieu of submitting a supplemental plan, a statement may be submitted to our Office after the 120-day period has elapsed stating that the information contained in the current plan of refunding remains valid. Such statement must be submitted by either the Chief Executive Officer or the Chief Financial Officer of the local government. We will acknowledge receipt of such statement and will issue our letter confirming that this refunding report remains valid for an additional 120-day period. However, with regard to the report currently being issued by this Office, during the initial 120-day period or any subsequent 120-day period no refunding reports will be issued relating to the debt obligations indicated herein

as being refunded unless the Chief Executive Officer or the Chief Financial Officer notifies our Office that the plan of refunding which has been submitted is no longer valid.

We recognize that the information provided in the Plan submitted to our Office is based on preliminary analysis and estimates, and that actual results will be determined by market conditions at the time of sale of the debt obligations. However, if it is determined prior to the issuance of these obligations that the actual results will be <u>significantly</u> different from the information provided in the plan which has been submitted, and the local government determines to proceed with the issue, our Office should subsequently be notified by either the Chief Executive Officer or the Chief Financial Officer of the local government regarding these differences, and that the local government was aware of the differences and determined to proceed with the issuance of the debt obligations. Notification to our Office will be necessary only if there is an increase or decrease of greater than fifteen percent (15%) in any of the following: (1) the principal amount of the debt obligations issued; (2) the costs of issuance; (3) the cumulative savings or loss with regard to any refunding proposal. We consider this notification necessary to insure that this Office and officials of the local government are aware of any significant changes that occur with regard to the issuance of the proposed indebtedness.

REPORT ON DEBT OBLIGATION

We are enclosing a revised State Form CT-0253, Report on Debt Obligation. Pursuant to Tennessee Code Annotated Section 9-21-151, this form is to be completed and filed with the Council no later than forty-five (45) days after the issuance of this debt, with a copy (including attachments, if any) filed by mail with the Director of the Office of State and Local Finance or by email to stateandlocalfinance.publicdebtform@cot.tn.gov No public entity may enter into additional debt if it has failed to file the Report on Debt Obligation.

Sincerely,

Justin P. Wilson
Comptroller of the Treasury

Cc: Mr. Jim Arnette, Director of Local Government Audit, COT
Mr. Brian Collins, Director of Finance, City of Memphis
Ms. Patrice Thomas, Comptroller, City of Memphis
Mr. Andre D. Walker, Deputy Director of Finance, City of Memphis
Mr. Wayne Placide, First Southwest Company
Mr. Steve Turner, Hawkins, Delafield and Wood
Mr. Stan Sawyer, Banks, Finley, White & Co.

Enclosures: Report of the Director of the Office of State & Local Finance
State Form CT-0253, Report on Debt Obligation

Attachments:
A: Grant Anticipation Note Resolution and Form (3)
B: Graphs re Debt Service (3)
C: Internal Control Weaknesses and Directives