MUNICIPAL BONDING

AN INTRODUCTION FOR LOCAL LEADERS

WORKFORCE SERVICES
HOUSING & COMMUNITY DEVELOPMENT
COMMUNITY DEVELOPMENT OFFICE

INTRODUCTION

The world of municipal bonding can be confusing and challenging to navigate. However, gaining a basic understanding of the key principles of municipal bonds opens up new financing resources for needed projects.

The purpose of this guide is to enhance understanding of municipal bonds among Utah community leaders, including elected officials, city staff, volunteers, and other stakeholders.

The information presented in this guide is primarily based on *The Fundamentals of Municipal Bonds* by Judy Temel; Volumes 1 and 2 of *Debt 101* created by the Government Finance Officers Association; and *Title 11, Chapter 14* of the Utah State Code.

The following questions are answered:

- *What is a bond?*
- *What are the types of bonds?*
- *Why bond?*
- *Who can bond?*
- *Who are the common players in the bonding process?*
- *What are the effects of bonding on the budget?*
- *What is involved in bond issuance?*
- *What are the on-going requirements of bonding?*
- *What are alternatives options to municipal bonding?*

WHAT IS A BOND?

A municipal bond is a form of debt created when a local government borrows money from investors. These investors can be individuals, banks, insurance companies, or other governments. The government entity that borrows the money issues the bond, which is a legally binding promise to the investors to repay the borrowed money in addition to interest.[1]

Bonds are essentially a loan. The government that borrows the money repays the debt in increments over time. Typically, municipal bonds are used to pay for projects that have high initial costs—also known as capital costs. Rather than having to pay for the project upfront with city funds, the project cost can be spread out over time. This allows the burden of paying for the project to rest on the shoulders of the residents who are actually using the project.

The Utah Local Government Bonding Act (UCA 11-14) states that bonds may be used by government entities to acquire, improve, or extend various facilities and properties. Some examples include:

- *Buildings (e.g. fire station, courthouses, offices)*
- *Irrigation systems, dams, sewer treatment plants*
- *Flood control systems or storm sewers*
- *Recreational facilities (e.g., swimming pools, camps, fairgrounds, tennis courts, stadiums)*
- *Roads, bridges, gutters, sidewalks*
- *Educational facilities*
- *Electric generating systems*[2]

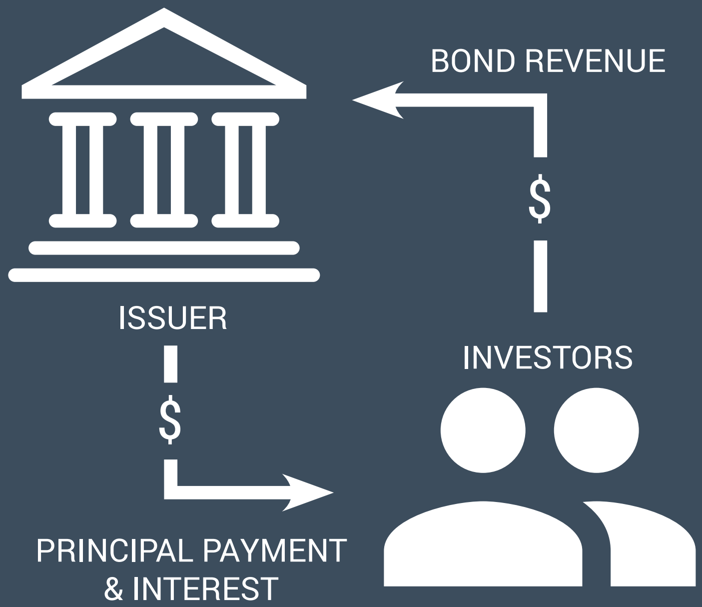


Figure 1 – Relationship Between Issuer and Investors

BONDING DEFINITIONS

Principal: the amount of money that the government entity borrows from investors

Interest: the amount of additional money that the borrower, in this case the government entity, needs to pay in addition to the principal amount

Interest Rate: the rate that determines the amount of interest that the borrower needs to pay the investor

Maturity: the date when the principal amount will be repaid to the investors

Collateral: the asset that the borrower promises to sell if for some reason it is unable to repay the debt to the investors[3]

WHAT ARE THE TYPES OF BONDS?

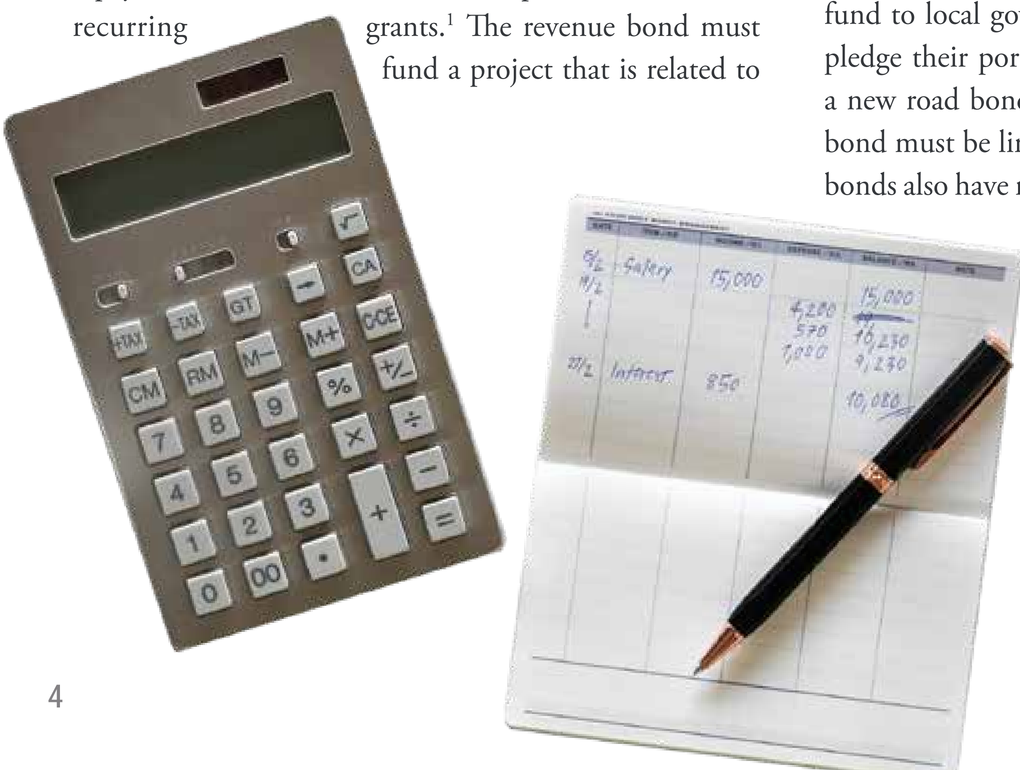
While many different types of bonds exist in the U.S. bond market, municipal bonds typically fall into one of two categories: ***general obligation (GO) bonds*** and ***revenue bonds***.[1] The distinguishing factor between GO bonds and revenue bonds is the revenue stream, or collateral, used to repay investors.[1]

GENERAL OBLIGATION BONDS

Most GO bonds are backed by the "full faith and credit" of the government entity issuing the bond. ***Full faith and credit*** means that the issuer is pledging its taxing power as the collateral for the bond payments. Thus, all non-restricted revenue sources that the government receives can legally be used for the debt payments. Because GO bonds are backed by the entity's taxing power, issuers are required to create a ballot initiative to ensure the community is in favor of the bond proposal.[1] Furthermore, since the entire community will be paying for the project with their taxes, GO bonds are typically used for projects that have a widespread community benefit.

REVENUE BONDS

Instead of pledging the full faith and credit of the organization, governments can also issue revenue bonds. These bonds pledge a specific revenue source for the repayment of the bonds, such as specific taxes, fees, or recurring grants.[1] The revenue bond must fund a project that is related to the revenue stream that is pledged. For example, a water revenue bond must pay for a water-related project and cannot be used to pay for a road project.



One specific type of revenue bond is a tax-revenue bond. A ***tax-revenue bond*** exists when a specific tax-revenue is used to repay bondholders. For example, a gas tax could be pledged to pay for a new road project. Because the government entity is pledging a revenue that is related to the funded project, the bond is considered a tax-revenue bond. Revenue bonds do not need to go through a ballot initiative.

Non-tax revenue sources can also be used for revenue bonds. Some of these revenue sources include electricity charges, water fees, sewer fees, tolls, landing fees, and disposal fees.[1] Even in non-tax revenue bonds, the pledged revenue still must be related to the new project. For example, sewer fees could be used to pay for a new sewer pipe but could not be used to pay for new electric infrastructure.

Some revenue sources have restrictions that need to be considered prior to securing them as collateral for a bond. Utah's Local Government Bonding Act describes some of these restrictions in detail. For example, in Class B and C Road Funds, the State allocates some of its road revenue fund to local governments.[4] Local governments can then pledge their portion of the road revenue as collateral for a new road bond. However, the Utah law states that the bond must be limited to ten years.[2] Mineral lease revenue bonds also have maturity restrictions. The state code limits the duration of these bonds to 15 years after the issue date.[2]

WHY BOND?

Generally, bonds are used to finance large capital-improvement projects that have high up-front costs. Since these types of projects are expensive, other forms of financing present challenges, especially for communities with limited revenues. Because bonds are designed in a way that provides all of the project funding at the beginning of a new project, they are not typically used to fund the day-to-day operations, such as paying employee salaries or covering maintenance costs.[1]

Bonding has many benefits including:

1. The issuer receives all of the money at the beginning of a project. This prevents delays in construction since the money for the project is readily available.

2. Issuers pay back the bond payments over a long period of time. Since the payments are made over time, those who benefit from the project in future years are also able to help pay for the project through taxes and service fees.

3. Municipal bonds improve budget stability. Payments are made over time rather than one large lump sum payment. This prevents large fluctuations in tax and rate increases as well as dips in fund balances.

It is important to note that certain situations exist where bonding may not be appropriate. For example, the Utah State Code states that bond proceeds may only be used for operation and maintenance costs for up to one year after the community starts using the bond.[2] Thus, leaders should carefully consider whether or not they will be able to pay for the operation and maintenance costs for the new project without using bond proceeds.

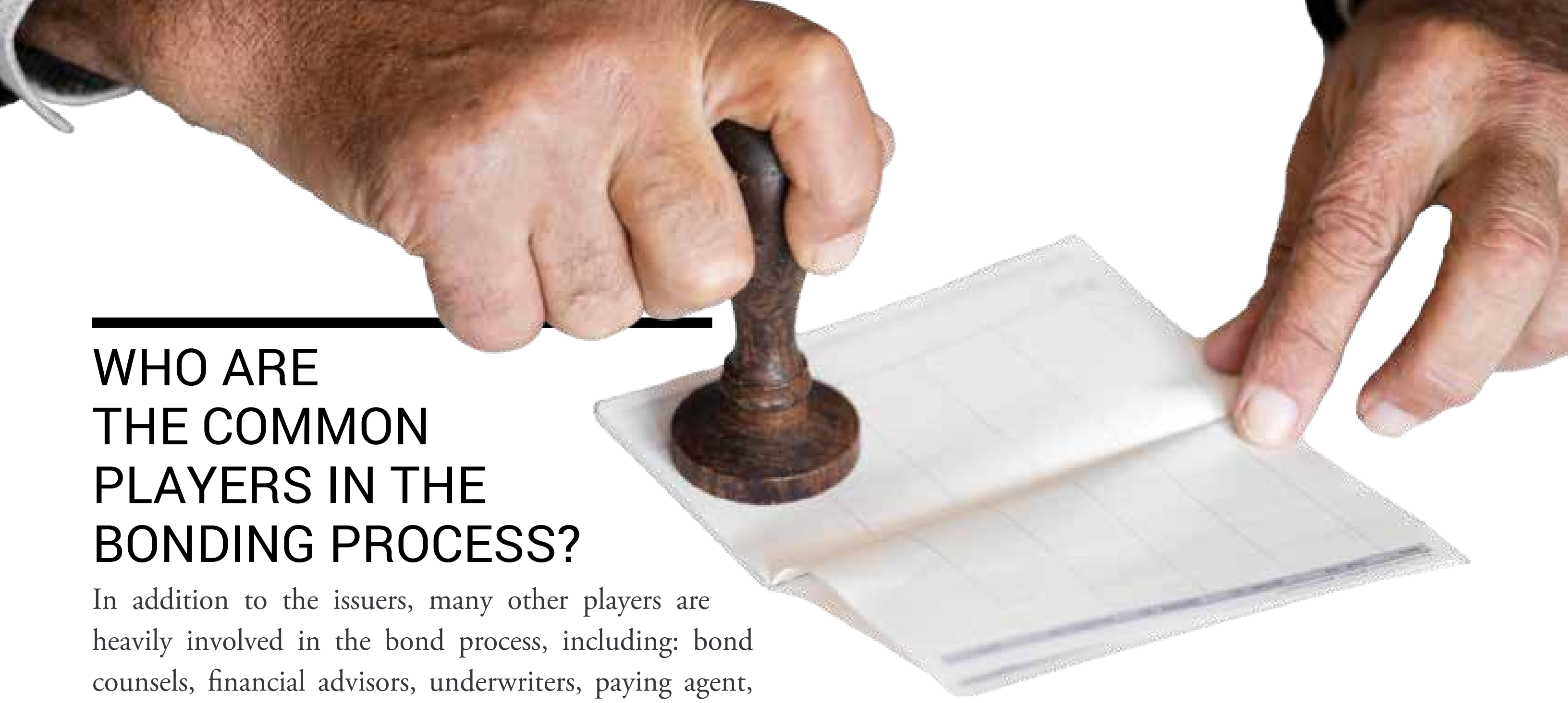
Furthermore, bonding is also inappropriate for a project that has a short useful life since the bond maturity would last longer than the useful life of the asset. Bonds should also not be used when the issuer is not in a financial position to make the debt service payments or when no secure revenue sources exist for bond repayment.

WHO CAN BOND?

Government entities and public colleges are common issuers in the municipal bonding market.[1] Government entities may include:

- *States*
- *Counties*
- *Municipalities*
- *Towns and townships*
- *School districts*
- *Special districts*
- *Local authorities* [1]

An authority is a local or state organization that is often created to issue bonds. Examples of common authorities include housing authorities, transportation authorities, and energy authorities.[1]



WHO ARE THE COMMON PLAYERS IN THE BONDING PROCESS?

In addition to the issuers, many other players are heavily involved in the bond process, including: bond counsels, financial advisors, underwriters, paying agent, rating agency, and credit enhancers.

BOND COUNSEL

The bond counsel is composed of either one attorney or a group of attorneys who work directly for the issuer. The bond counsel issues an opinion about the validity of the debt obligation as legal and binding and the taxability of the interest earned by the investors of the bond. Bond counsels should have strong knowledge of municipal finance, including laws and requirements for public agencies.[5]

FINANCIAL / MUNICIPAL ADVISOR

Financial advisors or municipal advisors are also important players in the bond process. They are consultants who work directly for the issuers. Their main purpose is to work with the issuers and bond council to develop an appropriate structure for the bond and to market the bond. They also manage the bond sale and help with the bond closing process. These advisors must be registered with the Securities and Exchange Commission (SEC).[5] Municipalities can identify registered municipal advisors on the SEC website.[6]

UNDERWRITER

Underwriters typically purchase bonds and then resell them to investors, such as households, insurance companies, and commercial banks.[1,5] Underwriters are important in the bonding process because they help the issuer determine the structure of the bond including interest rates, maturities, and debt service payments. The underwriter's role varies depending on the method of sale. Not all governments use underwriters. In these situations, other players such as financial or municipal advisors help the issuer structure and sell the bond.

TRUSTEE/PAYING AGENT

Trustees or paying agents are in charge of carrying out the administrative responsibilities defined in the bond documents.[1] Some of the trustee's main responsibilities include the following:

- *Creating the proper accounts*
- *Holding the bond funds*
- *Retaining a current list of the bondholders*[1]
- *Taking interest and principal payments from issuers and distributing them to investors*[1,5]
- *Representing bondholders in case a bond default occurs*[1]

For many local governments in Utah, various state agencies, such as the Community Impact Board, Department of Transportation, and Department of Water Quality, serve this role.

RATING AGENCY

A ***bond rating*** is a score of the quality of the issuer's credit. Most bonds are typically rated prior to being sold. Large bond sales require ratings. To determine a rating, rating agencies review the issuer's financial information and determine the issuer's ability to repay the debt to the investors.[1] Higher ratings indicate a lower risk of bond default and may lead to a lower interest rate for the bond.[5]

Some bond issues can be sold without a rating if strong market conditions exist or if the issuer is unable to obtain an investment-grade rating.[1] If an issuer chooses to obtain a credit rating but receives a low rating due to poor financial health, the issuer will have a more difficult time selling the bond issue.

The three main rating agencies in the municipal bond market are Standard & Poor's, Fitch, and Moody's Investors Service, Inc. Rating scales differ for each rating agency; however, a AAA rating is considered the best rating among all three agencies.[1]

CREDIT ENHANCER OR BOND INSURANCE PROVIDER

In credit enhancement, the credit rating of a higher-rated organization is used to strengthen the rating of the issuing entity. Whereas, in bond insurance, an insurance provider makes a legally binding commitment to make the debt service payments in the event that the issuer is unable to pay for the payments themselves. Some examples of bond insurance providers are commercial banks or insurance companies.[1] Both credit enhancement and bond insurance can reduce the overall investment risk associated with the bond.

WHAT ARE THE EFFECTS OF BONDING ON THE BUDGET?

While bonding may seem like a quick way to receive money, local leaders should carefully consider the effects of bonding on their budget prior to making a decision. Bonding should not be a last minute decision. Instead, it is important for organizations to have a capital improvement plan that is current and well researched. The plan should identify upcoming projects, projected costs, and expected revenue. The capital improvement plan should identify when to bond, how much to bond, and the projects best suited for bonding.

In addition to having a strategic plan, local leaders should also ensure they will be able to make the payments associated with the bond. An ***amortization schedule*** can provide the information necessary to determine the annual debt service payment. The annual ***debt service payment*** represents the issuer's annual financial obligation to its bondholders. Issuers must have enough funding available in their debt reserve to pay future debt service payments.

Debt reserve and debt payments are important because they tie up revenue. The more debt an entity has, the less flexibility it has in its annual budget. Issuers need to understand that bonds are legal obligations. Bond payments must be paid each year, and the issuer needs to ensure it has the funds available to make the payments.

Furthermore, local leaders also need to be aware of limitations that exist in bonding. For example, some issuers may have debt limits, which are legal limitations on the amount of debt that their entity may have at any given time.[1] Restricted funds are also a common limitation. These funds are restricted to a specific purpose within the city and should not be used for debt service payments. When issuers are identifying the funds available for payments, restricted funds should not be considered.

After examining their budget, issuers may find that they are unable to afford a bond. If issuers do not think that their organization will be able to make the bond payments, they will need to identify ways to increase their total revenue or reduce total expenses. Some governments choose to increase revenue by increasing taxes or raising fees.

WHAT IS INVOLVED IN BOND ISSUANCE?

The bond issuance process starts by identifying whether or not issuers can afford to bond. The total project cost, future annual revenue, and future annual operations and maintenance costs all need to be considered.

After issuers are confident they can afford to bond, they will likely want to obtain a credit rating for the bond issue. High credit ratings can help attract a greater number of investors. During this stage, the issuer may want to use credit enhancement or find a bond insurance provider.

During or after the credit rating is obtained, entities will likely need additional expertise, such as a municipal securities dealer or underwriter, for issuing bonds on the open market and for finding a sufficient number of investors. This dealer or underwriter will help them determine the best method of sale.[5]

It is important to note than most local governments do not bond on the open market since the process is expensive and complicated. Instead, for many large projects, the bond process can be simplified through federal or state programs. For example, the Utah Community Impact Board (CIB) issues loans to communities with relatively low interest rates for certain types of projects.[7] The process for obtaining a loan from the CIB is much simpler than issuing a bond on the open market because the bond issue does not require a rating and the state acts as the underwriter. If municipalities are interested in obtaining a loan, they can use the CIB Loan Repayment Calculator to examine different loan scenarios and payment structures according to their financial position. This tool is available online: ruralplanning.org/loan_calculator.[8]

At the federal level, the USDA also offers loan programs for various community issues. For example, the USDA's Community Facilities Programs offer grants and loans to help rural communities develop public infrastructure and services.[9]

If municipalities decide to move forward with a bond and they attract sufficient number of investors, they will need to work through all of the legal documentation required. A trustee or paying agent will also need to be selected to carry out the administrative functions of the bond issue, such as maintaining a list of the current bondholders and paying the principal and interest payments.[1]

WHAT ARE THE ONGOING REQUIREMENTS OF BONDING?

Once the bonds have been issued, local leaders still need to satisfy many ongoing requirements.

Continuing Disclosure Agreement (CDA): The CDA outlines the specific financial information that the issuer must provide to the public on an annual basis.[10]

Tax Compliance: The issuer needs to ensure that they are complying with the tax rules for the particular bond issued. Federal tax rules often are concerned about the use of financial assets, expenditure proceeds, investment of proceeds, and recordkeeping.[10]

Policy and Compliance Program: Issuers should establish policies about their methods of compliance with the ongoing requirements for the bond. One specific individual should be assigned to monitor and ensure compliance with the requirements.[10]

Payment of Debt Service: Governments need to manage their funds to ensure that they will be able to make the debt service payments on the bonds. Failing to make the debt service payment can result in a default, which is very detrimental to the government entity. The Government Finance Officers Association (GFOA) recommends that issuers follow two specific recommendations with regards to debt service payments:

1. Establish "procedures and appropriate contractual terms for making debt service payments"[10]
2. Use "electronic fund transfers to ensure timely payments and to ensure full utilization of funds until the due date"[10]

WHAT ARE ALTERNATIVE OPTIONS TO MUNICIPAL BONDS?

Because of the expertise and knowledge required in municipal bonding, local governments may want to consider other types of financing.

Save Up and Set Aside: Some governments try to save up over time for large capital improvement projects in order to avoid going into debt. If the entity expects to have excess revenue that can be set aside for a future date, then this financing method may be useful. Unfortunately, this can take a great deal of time and can lead to delays for capital projects. Furthermore, UCA-10-6 limits the accumulation of the general fund balance to less than 25 percent of the annual general fund revenue.[11]

Pay-As-You-Go: Other governments try to save up money in small increments to pay for different aspects of projects over time. Once they have saved enough money to complete one phase of the project, they move forward with construction of that phase. However, when using this approach, governments can only work on projects as funds become available, which can potentially lead to delayed or incomplete projects.

Grants: Grant funding may be available for certain projects. For example, a local government may be able to obtain grant funding from the state government for a new outdoor recreation project. However, grants can often be difficult to qualify for and may have strict requirements for project type, timeline, and documentation. Communities who receive grants also often forget that operation and maintenance costs still apply, even when the upfront costs are covered by others.

Regionalization: Municipalities can also create a regional district with other entities to share cost burdens for specific assets. For example, a new swimming pool in a small community may consider forming a recreation district to pay for the pool from the multiple small communities who will use the pool within the region.

Bank Loans. Bank loans involve one specific entity borrowing money from a bank and repaying it over time. Available immediately, these loans can be flexible with regards to repayment and duration. They also can have fixed or variable interest rates. Typically, the duration of these loans is shorter than the duration of bonds. Thus, it may be more appropriate to take out a loan for a small-scale neighborhood park than for a new city water system.[5]

Interfund Borrowing. Interfund borrowing occurs when funds from one account are loaned to a different account. These funds, in addition to interest, are then repaid over time to the original account. This type of borrowing is typically used for inexpensive projects, such as the purchasing of a new fire truck.[5]

It is important to understand that interfund borrowing can be restricted by policies and laws.[5] For example, the State of Utah limits the term and repayment schedule of interfund borrowing to 10 years, which can make the debt payments higher than they would be under a 20-year bond.[12]

CONCLUSION

Municipal bonds are a useful financing method that can open many new opportunities for local governments. Even though the process is fairly complicated, local governments can learn to navigate the bonding process with practice and patience. As community leaders gain a stronger understanding of municipal bonding, they will be better able to provide necessary community services to their residents.

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