What types of TIF-related bonds do local governments issue?

Tax increment or tax allocation bonds represent debt financing for TIF-related projects. Although sometimes defined as bonds solely supported by incremental revenues, it is defined more broadly to include bonds supported by: Incremental revenues (revenue bonds); The full faith and credit of the issuer (general obligation bonds); or A mix of the two.

Governments may support TIF bonds not only with incremental property tax revenues (which are often formally pledged) but also with sales tax and other revenues that are projected to increase during the life of the project. TIF-related bonds can be issued either by the city or county government that sponsors the TIF, or in some states by a redevelopment agency (typically a subsidiary of the government) empowered to issue bonds.

There is a tradeoff between the risk of the financing instrument and the interest rate. A government can absorb the risk of a bond issuance by issuing general obligation (GO) bonds, extending its full taxing powers to support the bond issue, and thereby reducing the risk to bondholders. While this results in a lower interest rate, governments in fact are taking on the risk that the TIF project will be financially viable. If it fails, government taxpayers are still responsible for retiring the bonds and would have to draw upon general fund revenues.

What Is a Bond?

A bond is a debt instrument that allows issuers to finance capital needs or refinance prior debt. It obligates the issuer to pay to the bondholder the principal plus interest.

- A buyer of the bond is the lender or investor.
- A seller of the bond is the borrower or issuer.

When an investor purchases a bond, he/she is lending money to a government, municipality, corporation, federal agency or other entity. In return for buying the bond, the issuer promises to pay the investor interest during the life of the bond and to repay the face value of the bond (the principal) when it "matures," or comes due. In addition to operating covenants, the loan documents require issuer to spend the bond proceeds for the specific projects. Among the types of bonds an investor can choose from are: U.S. government securities, municipal bonds, corporate bonds, mortgage and asset-backed securities, federal agency securities and foreign government bonds, among others. A bond can also be thought of as a contract between the issuer and investor. This contract specifies, for example, the terms of the bonds, the funds from, which debt service will be paid and any operating covenants.

What Is a Municipal Bond?

Municipal bonds represent a promise by state or local agencies or political subdivisions issuers to repay to investors (bondholders) an amount of money borrowed, called the principal, along with interest according to a fixed payment schedule. Municipal bonds generally are repaid (mature) from one to 30 years from the date they are issued.

Just like any borrower, State or local governments pay interest on municipal bonds to the bondholders usually once every 6 months. The major benefit to bondholder is that the interest earned from municipal bonds is tax-free in terms of federal income taxes. The interest from municipal bonds can also be free of state income taxes, local income taxes, and the alternative minimum tax (AMT).

The major advantage to Munis is that the returns are free from federal tax. Furthermore, local governments will sometimes make their debt non-taxable for residents, thus making some municipal bonds completely tax free. As a general rule, if you live in the same state as the local government that is issuing the bond, the interest to you on such a bond is tax-free on a state level as well. For instance, a Georgia resident owning a Marietta School District bond would not have to pay federal or Georgia income tax on the interest received from the bond.

Because of these tax savings, the yield on a Muni is usually lower than that of a taxable bond. Depending on the bondholder situation, a Muni can be an attractive investment on an after-tax basis

Why Do States/locals Issue Bonds?

By issuing municipal bonds, State and local governments borrow money to fund for its long-term capital needs such as build bridges, roads, public transportation system, hospitals, schools, sewer systems, stadiums, airports, power plants, prisons, and provide for other needs of local governments. Municipal bonds are generally issue by state and local government to raise money for major capital projects that:

- are large enough to merit borrowing rather than pay-as-you with the costs of delay outweighing the costs of financing,
- can spreads costs of a capital asset over time to all those who benefit from it
- are short-term borrowings for smoothing out cash flow imbalances, not as a way to balance the budget

For what purposes can tax-exempt bonds be issued?

Federally tax-exempt debt may be issued to finance governmental purpose projects. This means that the project must benefit the public in general. Examples of governmental purpose projects are roads, bridges, public transportation system, schools, and fire stations, etc.

In addition, certain “private activity” bonds are sold on a tax-exempt basis. The Internal Revenue Code define private activity bonds as those for which

1. more than 10% of the proceeds of the bond issue is used to finance facilities to be used by a private entity (nongovernmental person), and
2. more than 10% of the bond proceeds is secured by payments from private sources.

Bonds issued for construction or improvements of governmentally owned and operated docks and wharves, airports, water and sewage facilities, facilities for the local furnishing of electric energy or gas, and solid waste disposal facilities may be designated as private activity bonds under the federal tax code definition. Nevertheless, they are permitted to be issued on a tax-exempt basis. There are many other types of private activity bonds which are qualified 501©(3) bonds. These securities are issued for projects of Section 501©(3) non-profit organizations such as educational or health care facilities. Because federal tax law governs the types of projects for which tax-exempt bonds may be issued, as well as investment of bond proceeds, refinancing of debt, and other activities, it is essential for issuers to stay abreast of changes.

How Many Municipal Bond Types

There are two main categories of municipal bonds: General Obligation (GO) Bonds and Revenue Bonds. There are some hybrids but in order to understand it, you must understand the distinction between GO and Revenue bonds.

- **General Obligation Bonds** - Principal and interest payments on general obligation bonds (“GO bonds”) are secured by the full faith and credit and taxing powers of the bond issuer. The GO bond issuer has the authority to levy and collect taxes. GO bonds are generally not secured by a mortgage on any particular property. If the issuer defaults on its obligation to pay debt service on GO bonds, the bondholders have the right to go to court to compel the issuer to raise taxes sufficient to pay debt service on the bonds. In certain cases, the issuer may agree to pay debt service on the bonds from specific taxes.

While GO bonds typically are the least expensive debt financing available to a government, there are drawbacks to issuing GO bonds in certain situation. GO bonds require voter approval, which may delay the financing of a project, or cancel the project outright. Furthermore, the ability to issue GO bonds may be constrained by legal debt limits.

- **Revenue Bonds** – Principal and interest payments on revenue bonds are secured by the revenues-producing enterprise such as a water, sewer, electric or gas system, a toll bridge/road, value capture revenue sources (i.e. Tax increment bonds or special assessment bonds), airport, hospital, college dormitory or other revenue generating facility.

  Although GO Bonds are almost always governmental bonds, Revenue Bonds may be either governmental bonds or private activity bonds. Revenue Bonds are usually analyzed in terms of the earnings, historical or potential, of the revenue source, compared with bond requirements. The yield generally is higher than GO Bonds

  Example:

1. The State A issues bonds and uses the proceeds of the bonds to finance a toll road. The debt service on the bonds will be paid solely from the toll collected from the users of the toll road by the state A. The bonds are revenue bonds.
2. City A issues bonds and uses the proceeds of the bonds to finance its infrastructure improvements to spur redevelopment. Debt service on the bonds will be paid solely from the tax increment payments received by City A. The bonds are revenue bonds

The bondholders of revenue bonds may have a first lien on the revenues of the facility financed with the proceeds of the bonds. If the issuer defaults on payment of debt service on the bonds, the bondholders may exercise any remedy against the issuer and the facility, including foreclosing on the facility. In general, failure to comply could result in loss of an issue's federal tax exemption.

Procedure for Issuing Municipal Bonds

The figure1 is a brief outline of the procedure for developing a capital plan and issuing bonds to finance projects identified in a capital plan or state transportation improvement plan. The circumstances surrounding any particular bond issue are unique, and therefore, a particular bond issue may develop differently than outlined below and additional steps may be necessary.

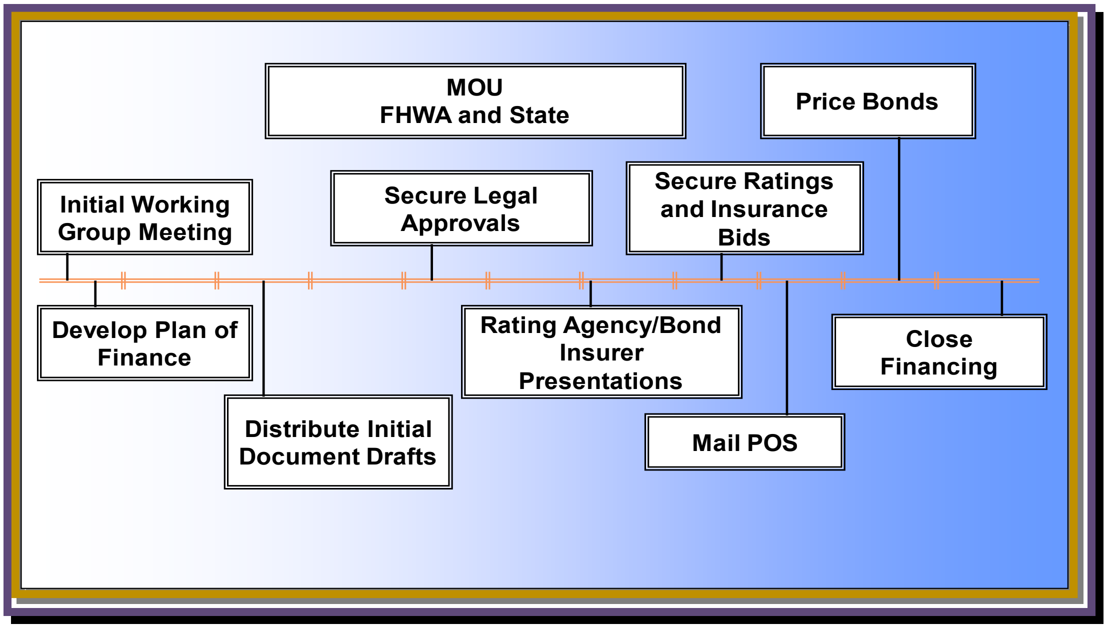


Figure 1: Outline of the procedure for developing a capital plan and issuing bond (Credit to FHWA)
ALT: Steps in the Process of Issue Municipal Bond

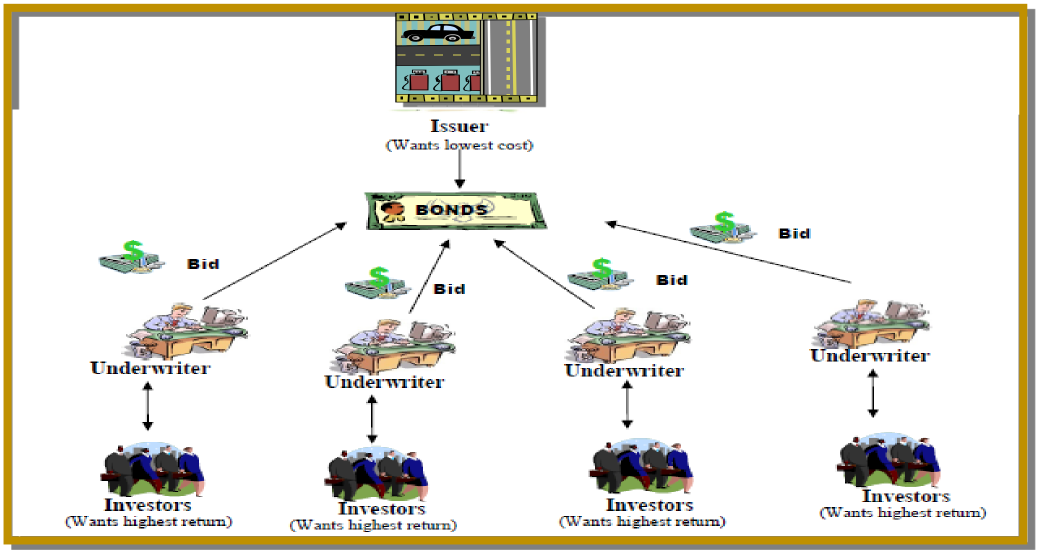
Developing of Capital/Financial Plan

The most fundamental part of any bond issue is to determine whether a capital need exists. Once capital need is identified, State or local government develops capital plan identifying the timing of the need for a capital project and the estimated costs. If state or local government decides to issue bonds for the project, the amount of bonds to be issued and estimated debt service requirements for the bonds are generally estimated according to the project master schedules.

Determination of Competitive Bid/Negotiated Sale

State or local government must determine whether to sell the issue of bonds at competitive bid or by negotiated sale.

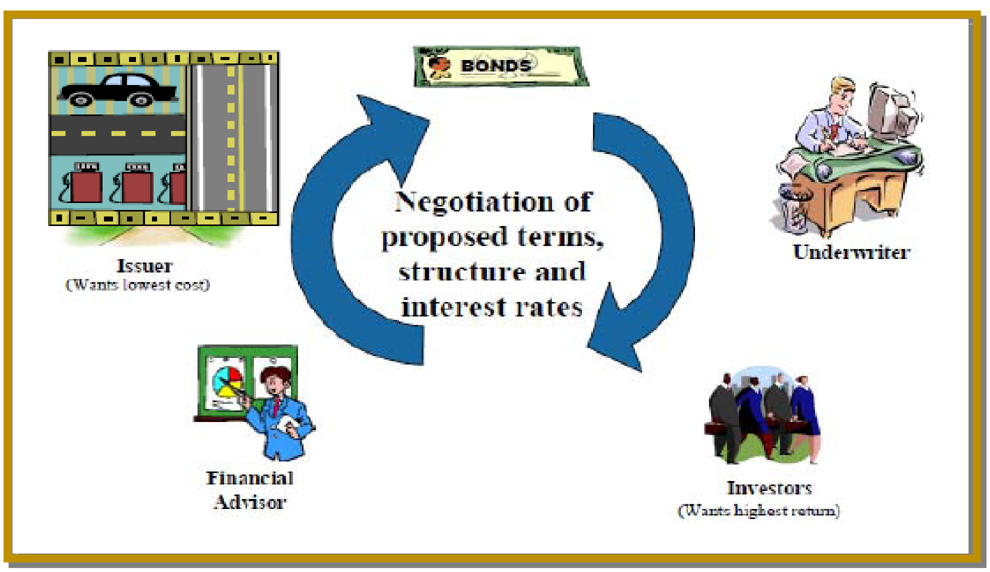
- **A competitive bid** entails sending out a bid package to a number of investment banking firms describing the terms of the bonds. The bonds are awarded to the bidder which submits the bids with the lowest overall interest cost to the state or local government. The picture below demonstrates the competitive bid process.



Source: Credit to FHWA

ALT:

- ***In a negotiated sale***, state or local government selects an underwriter usually pursuant to some form of request for proposals to assist it in structuring the bond issue and to advise state or local government regarding market timing and other factors issuer should consider. The underwriter purchases the bonds at a time and price determined by issuer and the underwriter. More than 65% of all municipal bonds in the United States are now sold in negotiated offerings. The picture below shows the negotiated sale process:



Source: Credit to FHWA

Selection of Financing Participants

Once issuer determines whether to sell bonds at competitive bid or negotiated sale, issuer and its staff must select the participants to the bond issue, including bond counsel, financial advisors, feasibility consultants, paying agent/registers and underwriter, if any. Some issuers might simplify this process by entering into a long-term arrangement with the various members of the financing team so that a new selection process does not have to occur for each bond issue.

Credit Enhancement

If issuer chooses to provide credit enhancement for its bonds issue, a credit provider must be identified. Each credit provider generally has certain requirements which need to be incorporated into the bond documents and the terms of the credit facility must be described in the Official Statement. As a result, the credit enhancer must generally be selected prior to mailing a preliminary Official Statement.

Structuring

After the key parties to the financing are determined, issuer's financing team should meet to discuss and determine the structuring of the bonds, including timing, call features, any, rating agency strategy and other seminar issues.

Initial Board Authorization

Before bonds can actually be offered for sale, the issuer must obtain its board/city council to adopt a resolution authorizing the staff to take the steps which are necessary to sell the bonds, including the method of sale and the maximum amount of bonds which may be issued. If a negotiated sale is contemplated, the resolution should also request the consent of the local governments.

Consent of Local Governments:

In some situation where consents from local governments are required for the bond issued, If negotiated sale is chosen, each of the participating local governments must pass a resolution or ordinance consenting to the negotiated sale.

Preparation of Basic Bond Documents

The next major step would be preparation of the bond resolution and/or the supplemental trust indenture which would govern the basic terms of the bonds.

Validation

Some agencies required a validation of up to certain amount of bonds under each indenture. If a proposed bond issue uses a structure which was not contemplated under the indenture, or if the principal amount, the annual debt service or the maximum interest of the proposed bond issue s in excess of what was validated, a new validation processing must occur. Such a proceeding generally requires at least three weeks to several months depending on the jurisdiction.

Preparation of Sale Documents – Official Statement

Together with the other members of the financing team, issuer's counsel would prepare, or assist in the preparation of, the Official Statement. In addition, the financing team would prepare notices of sale and other bid documents or bond purchase agreements in the case of negotiated sale.

Rating Agencies

The financial advisors will assist issuer in obtaining a rating of each bond issue. In addition, in light of today's troubled economy and the increasing pressure on local revenues, at least annual communication with rating agencies and major investors is critical. Financing team members will assist issuer in developing a strategy for presenting issuer and its finances to the rating agencies and in its periodic communications with the rating agencies.

Pricing

After the bond and offering documents have been finalized and ratings have been signed, the bonds are sold pursuant to an award in a competitive bid or negotiated sale. At this time, the issuer Board and executive would either approve or reject the sale terms. Generally, financing team participants keep the issuer legislators or public officials informed regarding market conditions and the acceptance of the bid or sale proposal is largely a formality.

Award Resolution

At this time of pricing, the Board or the public official would adopt or approve the basic bond documents.

Finalize Bond Official Statement

Within seven business days after the pricing, issuer is required to deliver final Official Statements to the bon purchasers. At least two days before the closing, issuer is required to deliver the bonds to the paying agent/registrar.

Closing

Although there are many certificates and opinions delivered at closing to evidence compliance with all or the legal steps necessary for the issuance of the bonds, the closing is basically the time and place during which the issuer delivers the bonds to the purchasers in exchange for payment of the purchase price.

Plan of Financing-Preparing the Capital Improvement Plan. Why is a capital improvement plan essential to long-term borrowing?

The most fundamental part of any bond issue is to determine whether a capital need exists before undertaking a long-term debt financing. State and local governments must have a clear understanding of the types of projects they intend to finance and when the projects will be implemented. Development of capital improvement program plan is an essential first step in preparing of issue bond.

A capital improvement plan identifies projects to be funded, funding sources, and project expenditures over the planning horizon. The capital improvement plan is a management tool that assists financial managers to:

- Established priorities in order to balance capital needs with all available funding;
- Match projects with appropriate funding alternatives;
- Ensure that debt-financed projects do not exceed legally or statutorily permitted levels of debt insurance, and
- Plan for debt issuance to meet expenditures requirements

In addition to serving as a planning, financing, and management tools, a well-prepared capital improvement plan is viewed as a positive factor by the credit rating agencies in evaluating the credit quality of a jurisdiction. A capital improvement plan demonstrates a jurisdiction's commitment to systematically replacing or improving its capital infrastructure. It also provides evidence that a state/local government has evaluated its long-term financial resources and has developed a plan to meet both operating and capital needs.

Should capital programs rely solely on debt financing?

Capital needs exceed available resources in many state and local jurisdictions. Before issuing debt, state/local government should evaluate all potential capital funding resources for the planning period. These include intergovernmental grants from federal, state, or other sources, state revolving funds or loan pools; current receipts and fund balance available from prior years; private sector contributions through impact fees, service contracts, or public-private-partnerships; and leasing. A systematic review of all funding alternatives will help a jurisdiction to maximize resources available for its capital program. Funding alternatives, which are appropriate for some activities but not for others can be target early, thereby ensuring that these options are not closed off before they are given full consideration.

When reviewing various funding alternatives, governments need to be realistic in their assessment of whether certain funds or financing methods will be available or are feasible. For example, some financing methods may entail a higher degree risk than the community is willing to take. Other financing methods will be new for a jurisdiction or involve such complexity that significant costs for legal and financial advice will be incurred. Additional time will be needed to gain consensus among interested parties on the use of these methods. Finance professionals may decide that such alternatives, while allowing the jurisdiction to maximizing its capital resources, involve transaction costs that are too high or are politically unacceptable.

What Factors Should Be Considered in Choosing a Capital Financing Method?

State and local governments should be guided by three general principals when selecting a funding source for capital improvements: equity, effectiveness, and efficiency.

Equity is achieved if the beneficiaries of a project or service pay for it. For example, it can be argued that since the community as a whole benefit from the public school system, public school buildings are appropriately financed from general tax revenues. Alternatively, certain facilities, such as water supply systems, benefit specific users. Financing for these types of capital facilities should be derived from user fees.

An effective financing method is one that provides a sufficient amount of funding when it is needed. Governments will generally have difficulty amassing sufficient funding from current receipts to pay for major capital improvements. Relying on available cash for these types of improvements would be an ineffective financing method.

Efficiency refers to the relative costs of using one financing method over another. As discussed earlier, governments may decide that certain financing methods have financial or non-financial costs or risks that are too high relative to the benefits they generate. Such financing methods may be regarded as inefficient.

What Factors Should be Examined When Deciding on The Mix of Pay-As-You-Go and Debt Financed Projects? For most jurisdictions, an important consideration is whether to pay for capital improvements from current revenues (pay-as-you-go) or issue debt. Debt is appropriate to finance assets with high capital costs and long useful lives. In accordance with the equity principle, taxpayers of several generations will both benefit and pay for the project, and no one group of taxpayers will be unfairly burdened. The maturity of the debt should not, however, exceed the useful life of the project being financed.

Some pay-as-you-go financing should be a part of every jurisdiction's capital finance program. Repair and replacement projects with short useful lives are not appropriate for long-term debt financing and should be considered for a jurisdiction's pay-as-you-go program. A carefully planned use of current revenues or fund balance for a pay-as-you-go program is regarded as a positive factor in credit analysis, in that the program provides a cushion that can be used for debt service payments in the event that anticipated future revenues do bit fully materialize.   Governments should exercise caution, however, when drawing down fund balance revenues for capital purposes. Significant reduction of fund balance restricts a government's flexibility in responding to unanticipated revenue downturns or other emergency situations.

Developing A Debt Policy. What is a debt Policy?

Once a jurisdiction decides to issue debt, it should develop a formal debt policy to establish parameters and to provide general direction in the planning and implementation of a debt program. Debt policies should be formally submitted to and adopted by a jurisdiction's elected officials. A debt policy will encompass several elements. Among the more common considerations will be:

1. Acceptable levels of both short-term and long-term debt;
2. Purposes for which debt will be issued;
3. Use of tax-supported, general obligation bonds versus self-supported, revenue bonds;
4. Mix of pay-as-you-go and debt financing;
5. Use of variable rate debt; and
6. Debt maturity schedule.

In setting policy goals in each of these areas, governments will be required to undertake a comprehensive review of a variety of factors affecting the financial position of their jurisdiction. For example, establishing a policy on acceptable levels of debt will require and understanding of the legal limitations on debt issuance, service levels and other factors affecting long-term operating expenses, debt commitments of other government entities relying on the same tax bases, and demographic and economic trends affecting the community.

Why Develop a Debt Policy?

A debt policy offers a number of advantages. First, a debt policy can help community leaders to integrate the issuance of debt with other long-term planning, financial, and management objectives. A debt policy us also useful once bonds are issued to evaluate the impact of each issue on the jurisdiction's overall financial position. Finally, a debt policy provides guidance to community leaders so as not to exceed acceptable levels of indebtedness. While debt policies are beneficial in establishing a framework for debt issuance, they should be sufficiently flexible to permit governments to take advantage of market opportunities or to respond to changing conditions without jeopardizing essential public services. A carefully crafted and consistently applied debt policy provides evidence to the rating agencies of a community's commitment to controlled borrowing practices.   As such, it is regarded positively in evaluating a jurisdiction's creditworthiness.

Choosing A Debt Instrument: GO Bonds, Revenue Bonds, or Notes

General Obligation Bonds: GO bonds are typically issued to finance government improvements benefiting the community as a whole. These obligations are secured by an unlimited tax levy of the issuer; that is, the issuer pledges to levy the necessary taxes on all assessable property within its jurisdiction to provide timely repayment of the debt. Due to the strength of this security pledge, general obligation bonds are readily accepted in the municipal marketplace, and usually have lower interest rates than comparably rated revenue bonds. General obligation bonds have a further advantage in that they do not require the issuer to create a debt service funds or use the services of a trustee, both of which may be necessary when issuing revenue bonds. Consequently, general obligation bonds can be issued at a lower cost relative to revenue bonds.

General obligation bonds have certain limitations of which the issuer should be aware. Many governmental entities are subject to state constitutional or statutory limitations on the amount of general obligation debt they may incur. Further, voter approval is often required in order to authorize the issuance of general obligation bonds. This requirement can limit the ability of the jurisdiction to entire the market quickly to take advantage of favorable market conditions. Debt limitations have, in some cases, necessitated the issuance of limited tax general obligation bonds. For this type of security, an issuer might pledge to levy property taxes up to a specified mileage rate to support debt service payments.

Limited Obligation Bonds: Limited obligation bonds are payable from a pledge of the proceeds derived by the issuer from a specific tax such as ad valorem tax levied at a fixed rate, a gasoline tax or a special assessment.

Revenue Bonds: Revenue bonds are issued to finance facilities that have a definable user or revenue base. These debt instruments are secured by a specific source of funds, either from the operations of the project being financed or from a dedicated revenue stream, rather than the general taxing powers of a jurisdiction; hence, revenue bonds are considered less secure than general obligation bonds. ***Voter approval is not usually necessary to issue revenue bonds***. Nevertheless, revenue bonds issuers are customarily required to set reasonable rates and charges, thereby limiting the amount of debt service that can be support by the facility. To enhance their security, some jurisdictions choose to issue double barreled bonds, which are secured both by a dedicated revenue stream as well as by the general taxing powers of the jurisdiction.

Revenue bonds are subject to more stringent issuance requirements than general obligation bonds. Issuers may be required to maintain a debt service reserve funds to be used for debt service payments if planned revenues from the facility's operations do not fully materialize. In addition, market conditions may compel issuers to enhance the credit of the bonds by purchasing bond insurance. Either option increases the cost of the borrowing for the issuer.

Issuers may also be subject to the provisions of a bond resolution or trust indenture, legal contracts that protect the bondholder by establishing the flow of funds from the issuer for payment of debt service. These contracts specify the rate covenants, the additional bonds test, and operation and maintenance requirements that must be met by the issuer.

Limited Obligation or Revenue Bonds with General Obligation Backup: A technique which is available to some issuers is the issuance of Limited Obligation or Revenue Bonds which are secured by both the pledge of revenues and the full faith and credit of the issuer. This technique allows the issuer to avoid voter referendum and, in most cases, give the bonds a higher credit rating than Limited Obligation or Revenue Bonds alone. In order to take advantage of the General Obligation back-up, the issuer must make a finding that the revenues pledged to the bonds are sufficient to repay the bonds.

Refunding Bonds: For federal tax purposes and in general reference, bonds are usually referred to as being refunded in one of two ways: 1) is a current refunding, in which the old bonds are actually paid within 90 days of the date of issue of the new bonds; 2) the other is an advance refunding in which the old bonds are paid at some time more than 90 days after the refunding bonds are issued. ***Advance refunding were eliminated on December 23, 2017, President Trump signed the Tax Cuts and Jobs Act (P.L. 115-97)***, the first major rewrite of the tax code since 1986. While the final bill retained tax-exempt status for municipal bonds, it eliminated the tax-exempt status of advance refunding bonds.

Notes: Notes are generally regarded as short-term obligations. Although many municipal credit analysts will label any tax-exempt security with a maturity of one-to-three years or less as a note, there is no clear industry-wide consensus as to how long an obligation can remain outstanding and still be classified as a note.

Generally, however, the method of payment and purpose are equally or even more important criteria than length of maturity. There are two broad types of notes. 1) one type depends on cash flow for note repayment. 2) the other type may not be retired fully from normal cash flows and depends on refinancing for its timely repayment.

Proceeds derived from the sale of Tax Anticipation Notes (TANS), Tax and revenue Anticipation Notes (TRANs), and Revenue Anticipation Notes (RANs) provide operating monies to meet regular payroll and other expenses.

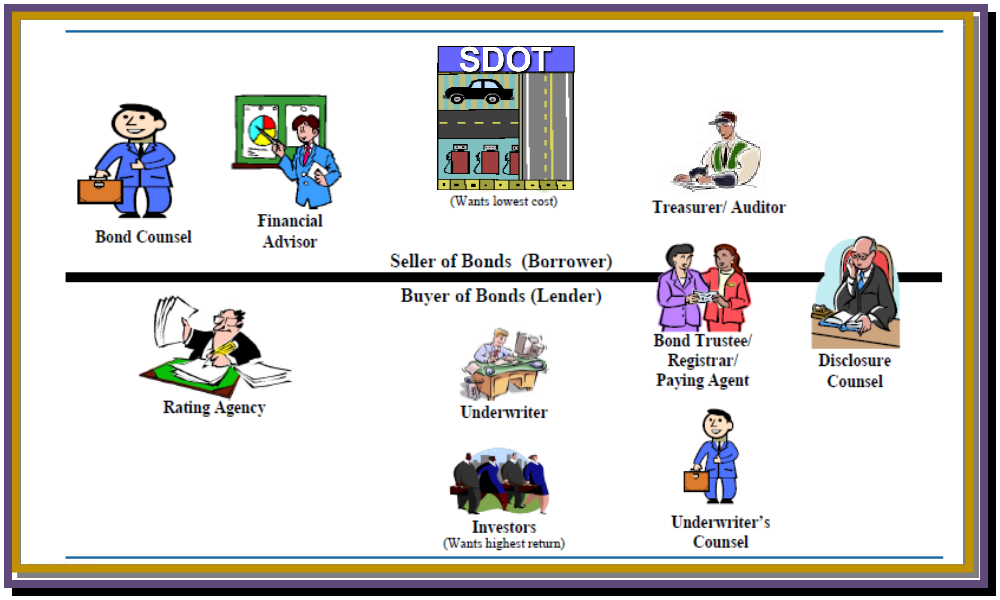
The second type of notes issued, usually Bond Anticipation Notes (BANs) and Grant Anticipation Notes (GANs), are designed to provide interim financing for construction projects and, as the names imply, are issued in anticipation of the issuance of bonds on the receipt of grant funds. BANs are frequently sold when long-term interest rates are high. The issuer's goal is to lower aggregate borrowing costs by not incurring long-term debt (bonds) until interest decline. Such notes also provide temporary financing until the construction of a facility is completed. This is frequently the case for issuing GANs, which are secured by the future receipt of grants. At the point of project completion, long-term bonds or, in the case of GANs, grant funds are used to retire the notes.

What Other Financing Instruments Are Available for Capital Improvements?

In recent years, governments have taken advantage of other types of financial instruments. Some of these instruments have become more prevalent as a result of difficult in getting voter approval for general obligation bond issues. These include the following:

Special Assessment or Special Improvement District Bonds: These bonds are issued to finance improvements that benefit a specific area. Because the benefit is largely enjoyed by a limited segment of the community, a special assessment to pay debt service is levied on properties benefiting from the project. The limited revenue pledge for special assessment bonds increases their perceived risk, resulting in higher interest costs.

Tax Incremental Financing *(TIF) Bonds: TIF bonds have been used by jurisdictions to promote economic development within a given geographic area. Debt service on TIF bonds is derived from the increase in tax revenues generated as a result of economic growth in the TIF district. TIF bonds can be highly risky during periods of economic downturn if economic growth needed to repay the obligation is not forthcoming or project financed with the TIF bonds cease to produce tax revenue.



Credit to FHWA for Roles and Responsibilities of Principal Participants

What General Qualifications Should They Have?

When selecting a financing team, the issuer must feel confident that participants have the necessary expertise to represent its interests and to successfully market its bonds. In general, the issuer should look for finance professionals with an understanding of the jurisdiction's needs, experience with similar types of securities, knowledge of beneficial approaches taken by other issuers, an understanding of innovative debt financing methods which can reduce costs or provide greater flexibility, and an ability to complete the transaction in a timely manner without undue burden on the issuer.

Compensation to the finance team is always a concern to state and local government finance professionals, fees paid to these individuals are funds that cannot be used for capital improvements. While issuers should strive to keep bond issuance costs to a minimum, they may not want to be guided solely by price in choosing finance professionals. Having a knowledgeable team that understands the objectives of the issuer, is able to identify create solutions to meet these goals and achieves savings on long-term borrowing costs is an equally important consideration which should be carefully weighed in the selection process.

What is The Role of The Issuer?

The issuer may be any entities authorized by the Internal Revenue Service (IRS) to issue tax-exempt securities.

- An authority is a special State and local governmental unites either directly or indirectly or through a special authority or agency. Example: State of Texas issues bonds and uses the proceeds of the bonds to finance George Bush Turnpike. State of Texas is the issuer.
- governmental unit created to issue bonds to run a project. Under the federal tax laws, the issuer must be a state or political subdivision which is defined as a legal entity with the ability to levy taxes, exercise eminent domain powers or excise police powers. An issuer can also be a legal entity acting as an instrumentality or on behalf of a state or political subdivision.
- Authorities usually issue bonds for themselves and also can be used to issue bonds for other qualified non-governmental entities such as not-for-profit hospitals, private colleges and private companies engaged in publicly beneficial activities.

Example 1: GA Toll Authority Industrial Development Authority of City A ("the Authority") issues bonds and loans the proceeds to Corporation X, a non-profit organization, to be used by Corporation X to construct a connector to GA 400. The Authority is the issuer.

Example 2: GA Toll Authority issues bonds and loans the proceeds to Corporation X, a for-profit organization, to be used by Corporation X to construct a parking facility. Corporation X will repay the loan to GA Toll Authority in amounts sufficient to make timely debt service payments on the bonds. Corporation X is the conduit borrower and GA 400 Toll Authority is Conduit Issuer.

What is The Typical Investor?

A bond financing structure must meet not only the needs of the issuer, but also the needs of the investor. Target investors in a bond financing have considerable influence in determining the features and structure of the bonds. Three classes of investors dominate the municipal market:

1. Households consist of individuals acting directly or through investment counsel;
2. Mutual funds typically classified as closed-ended funds;
3. Financial institutions which primarily commercial banks and property/casualty insurance companies.

The investment market for municipal bonds is one of the world's largest securities markets with over $4 trillion worth of municipal bonds in the hand of investors. The principal characteristic of all buyers of municipal bonds is that they are in a sufficiently high tax bracket that they can benefit from the tax exemption.

What is The Role of The Financial Advisor?

The financial advisor may be an individual, a consulting firm, an investment banking firm or a commercial bank that provides financial advisory or financial consulting services to state and local governments. A financial advisor usually assists the issuer in evaluating alternative financing techniques that may be used, structuring the financing to meet the needs of the issuer and coordinating the financing of the project. In addition, in a competitive bid sale, the financial advisor is responsible for advising the issuer with regard to timing of the issue, in identifying potential bidders and in identifying the best bid. In a negotiated sale, the financial advisor reviews the pricing structure proposed by the underwriter to ensure the bonds are competitively priced.

How is The Financial Advisor Compensated?

The financial advisor is usually compensated on an hourly or fixed fee basis, or as a percentage of the amount of bonds sold. This amount is usually expressed as a certain number of dollars per $1,000 bond (e.g. $1.00 per bond on a $50 million bond sale would result in a $50,000 fee). Issuers should exercise caution when paying the financial advisor based on the amount of bonds issued for two reasons. First, payment on a per bond basis may not adequately reflect the amount of work undertaken by the financial advisor on behalf of the issuer. Second, this method provides an incentive to advocate the issuance of bonds whether or not this financing method is most advantageous for the issuer. Payment on a hourly or fixed fee basis removes this potential conflict of interest.

What is The Role of The Underwriter?

The underwriter can be a firm or group of firms. The primary role of the underwriter is to purchase bonds from the state or local government (issuer) and to sell them to investors (bondholders). The extent of the additional role played by the underwriter depends on whether the issue will be sold at a competitive or negotiated sale.

In a negotiated sale, the underwriter, together with the financial advisor, acts as the chief coordinator of the financing and is responsible for recommendations regarding the overall plan, the structure of the issue, the amount of revenue flow available for repayment, the alternative sources of security, and the date of sale.

In a competitive sale, the underwriting firms bid against one another for an issuer's bonds. Underwriters determine their bid by reviewing the pricing of comparable issues, talking to potential investors, identifying other issuers that are likely to be in the market at the same time, and assessing the level of competition among various underwriting firms for the bonds. Bids are submitted just prior to the time established for bid opening.

How are The Underwriters Compensated?

Underwriters receive a gross spread (also know as underwriter's discount) for providing underwriting services to issuers. The gross spread is a percentage of the amount of bonds sold, and is expressed as a certain number of dollars per $1,000 bond. The gross spread consists of four components:

- ***Takedown***. Compensation to the underwriters for selling the bonds, sometimes referred to as sales commission.
- ***Management Fee***. The fee paid for the underwriters for financial advice, document preparation, and managing the activities of the bond syndicate.
- ***Underwriting Risk.*** Compensation to members of the underwriting syndicate for the risk involved in committing to buy and place the issuer's securities.
- ***Expenses.*** Costs incurred by the bond syndicate in the sale process (e.g. travel). Underwriter's counsel, if employed by the underwriter, is a significant expense often included in this category.

Compensation to the underwriters varies by method of sale. The gross spread will be reflected in the underwriter's bid when a competitive method of sale is used. In selecting the firm providing the most aggressive bid, issuers can be confident that they paid a fair price for underwriting services.

In negotiated sale, the issuer negotiates an amount with the underwriter fir each of the four gross spread components. The issuer has more control over some of these components than others. The management fee and underwriting risk are fees that the issuer will usually have greater flexibility in negotiating. The takedown, which is the largest component if the gross spread, is determined to a great extent by market conditions, the investors to which the securities are being marketed, and the type and maturity of the securities. Nevertheless, there may be some opportunity to negotiate this amount as well.

To the extent possible, the issuer must feel comfortable that the mounts paid to the underwriter reflect the level if effort and resulting interest rate obtained on the transaction. Ultimately, the goal is to compensate the underwriters sufficiently to provide an incentive for them to work aggressively on behalf of the issuer. At the same time, the level of compensation should reflect and understanding of what an underwriter can realistically achieve given market conditions.

What is The Role of Bond Counsel?

Bond counsel is generally an individual attorney or firm of attorneys qualified as experts in municipal financing. The role of bond counsel is to ensure that all proceedings from the selection of the financing method through the issuance of the bonds conform to all legal requirements. Bond counsel typically prepares all legal documents necessary to connection with the issuance of the bonds and renders an opinion regarding the validity of the bonds and the tax-exempt status of interest on the bonds.

The opinion of bond counsel provides comfort to investors in purchasing an issuer's securities, since it reduces the risk that bond contracts will be unenforceable or interest income includable in computation of federal income taxes.

Bond counsel should be selected by the issuer early in the proceedings because his or her contribution to the design and structure of the issuer is essential to determining the legal security required, the provision to secure payment of the debt to be incurred, and the implications of any decisions for the tax-exempt status of the issue.

When selecting a firm to serve as bond counsel, an issuer will be primarily interested in the strength of the firm's reputation in the area of municipal bonds. The degree of confidence of both issuers and investors in the opinion of bond counsel will be directly related to the firm's experience. The Bond Buyer's Municipal Marketplace (often referred to as The Red Book), is a directory of firms specializing in municipal bond sale, and is a good source of firms with national recognition in municipal finance.

How is The Bond Counsel Compensated?

Bond counsel is compensated on a fixed-fee or hourly basis, or as a percentage of the bonds sold. When negotiating these fees, issuers should consider the complexity of the issue, the degree if risk involved in the transaction, and the amount of work required to complete the transaction. As discussed earlier, it is often more difficult to adequately reflect these considerations when paying bond counsel on a per bond basis, since the amount of bonds issued is not always a good measure of the difficulty of the transaction.

What is The Role of Disclosure or Issuer Counsel?

Disclosure counsel is generally an individual or firm of attorneys that are nationally recognized as experts in municipal financings. The disclosure counsel is retained by the issuer to provide advise on issuer disclosure obligations and to prepare the official statement and continuing disclosure agreement. In some cases, the role of disclosure counsel is being performed by issuer's counsel.

The primary role of disclosure counsel is to ensure that the offering document prepared for the sale of municipal securities fully discloses every financial and legal aspect of the project, the issuer and the securities. Finally, disclosure counsel is responsible for review of all documentation prepared by other members of the financing team to ensure that the securities are being issued according to federal and state law and local regulations. If a financing were by negotiated sale, counsel will also need to research the local securities laws in each state (the blue sky laws) where the underwriter plans to distribute the securities and to prepare documentation regarding any local requirements and to represent the underwriter in connection with the preparation of the bond purchase agreement.

How is The Disclosure Counsel Compensated?

Because disclosure counsel works for the issuer, they are paid by the issuer from the proceeds of the bonds. Similar with bond counsel, compensation arrangements may include hourly rates, fixed or percentage fees, or a combination of methods, and may be contingent upon issuance of the bonds or payable regardless of the success of the transaction.

What is The Role of Underwriter Counsel?

Underwriter's counsel is customarily selected by the underwriter to represent the underwriter and its interest in negotiated sale. Normally, no underwriter's counsel is retained in a competitive sale. Underwriter's counsel will review from the underwriter's perspective the document prepared by bond counsel and will negotiate matters relating to those documents on behalf of the underwriter. Underwriter's counsel advises the underwriter on federal and state securities law issues, and renders an opinion on the issuance date that the offering documents:

- are true and correct,
- do not include a statement that is misleading, and
- do not fail to include any statement, the omission of which would be misleading

Rating Agency-Credit Rating Agencies
A rating agency is a firm that provides an opinion of the relative investment merit of the bonds. The three most common rating agencies are Moody's, Fitch, and Standard & Poor's. The rating is based upon the issuer's or the conduit borrower's credit worthiness. If the bonds have credit enhancement, the rating is based upon the credit worthiness of the credit enhancer. The rating on the bonds may be downgraded or upgraded after issuance depending on any changes in the long-term debt rating (or credit worthiness) of the party upon which the rating on the bonds is based.

Example1: State of Idaho issues bonds for the purpose of financing its office building. The bonds will be GO bonds. State of Idaho's long-term debt is rated "AAA" by a rating agency. The bonds will be rated "AAA.

Example 2: The GA State Tolling Authority issues bonds for the purpose of constructing additional lane to GA 400 project.   The GA State Tolling Authority enters into an agreement with a bond insurer to insure the debt service payments on the bonds. The bond insurer's long-term debt rating at the time of issuance of the bonds is "AAA." The bonds will be rated "AAA."

What criteria do rating agencies use to evaluate tax increment bonds?

Rating agencies generally rate bonds upon four sets of broad criteria. These criteria are especially relevant to general obligation bonds issued for a TIF district, but they generally apply to other TIF-related bonds as well

1. Quality of administration – These qualitative factors take into account the soundness of a government's general and financial management, such as establishment of rigorous annual and capital budgeting, adherence to investment policies, maintenance of effective employee relations, and other practices.
2. *Debt indicators* – These include debt capacity and using indices for existing and projected debt levels (e.g., direct debt, debt per capita etc.).
3. Financial performance – This factor assesses the government's budgetary performance, examining trends in revenues, expenditures, reserves, and fund balance as well as other measures.
4. Economic base – This factor considers the strength of the private sector supporting government-sector services. Measures include income, population, annual building permits, employment levels, and major taxpayers. Although the government does not have direct control over the economic base of its area, economic development efforts can serve to strengthen it.

When evaluating the creditworthiness of TIF-related bonds that are supported only by incremental revenues (non-GO bonds), rating agencies consider additional risk factors. These factors include

- Tax base concentration – A tax increment district often depends upon just a handful of large taxpaying businesses, such as a shopping mall's primary or anchor tenants; creditworthiness is enhanced by a greater number and more diverse variety of taxpayers.
- Market competition – Certain firms, such as retail businesses, may be subject to intense competitive pressure, or may face unexpected competition mid-way through the life of the TIF project. When this happens, the firm's revenues are eroded, which in turn depresses incremental property taxes and, if applicable, sales taxes.
- Revenue or rate limitations – With most TIFs, the government or redevelopment agency operating the TIF district cannot increase the tax rate to compensate for an erosion in the tax base. Any change in state

law governing property tax revenue (e.g., limiting increase in assessed value) makes it difficult for governments to realize projected incremental revenues.

What Other Types of Services May be Required in Issuing Bonds?

Issuers of government securities may require the service of other finance professionals. A description of some of the more commonly required services is provided below.

- ***Trustee/Paying Agent***: Trustee and paying agents are typically commercial banks or trust companies with trust powers.
  - Paying Agent/Registrar. Receives fund from the issuer and make payments to bondholders; also maintain records of bond ownership.
  - Trustee. Acts as fiduciary agent for the benefits of the bondholders in enforcing the terms if the bond contract.
- **Security Depository**. Maintains a record of ownership for bonds issued without physical certificates of ownership, known as book entry securities; also collects printed certificates, when issued, for distribution to investors.
- **Printer.** Prints, and sometimes distributes, official statements. A printing firm may also be engaged to print an issuer's bond.

Sizing and Structuring The Issue. What is Involved in Sizing a Bond Issue?

An early step in the bond sale process is determining the amount of bonds to be issued – that is, sizing the issue. Sizing the bond issue takes into account the cost of the project that is being undertaken, the costs associated with the issuance of the bonds, and interest earnings on invested proceeds. The bond proceeds and investment income must be sufficient to meet ask the necessary uses of the funds.

In addition to the construction costs of the project, bond proceeds are generally used for a number of issuance-related expenses. Depending upon the particular project being financed and the security supporting the payment if the bonds, bond proceeds may be used to pay interest on the securities for a period of time (known as capitalized interest) or to fund a debt service reserve funds. Funds for these purposed are most likely to be needed when the security supporting the bonds is the revenue flowing from the project being financed and not a jurisdiction's taxes.

Other costs paid from bond proceeds include fees which must be paid to legal and finance professionals. The issuer may also determine that, in order to improve their marketability, binds should be sold at a premium or discount, or with credit enhancement. These provisions can also affect the size of the bond issue.

What is Involved in Structuring of a Bond?

There are many variations on the structure and security for bonds. Bonds which are general obligations are payable from general funds of the issuer. Others are limited obligations payable from only a specified source of funds such as TIF Funds. Bonds can have one maturity date or multiple maturity dates. Bonds can have a fixed interest rate or a variable interest rate. A primary consideration in any financing plan is the relationship between the term of the financing and the life of the asset being financed.

Short-term versus Long-term Bond Issuance

Short-term borrowing is generally defined as debt maturing no later than one year after the date of its issuance. The two basic reasons for borrowing short term are to smooth out cash flows due to the timing of tax receipts and to cover start-up costs for large projects until the actual final costs are known.

For example, short-term operating needs are generally financed with short-term borrowing, such as a "tax and revenue anticipation note" (TRAN), while a capital asset, such as a bridge, is typically financed with a debt instrument having a longer maturity. Long-term debt is usually defined as bonds or other obligations with maturity of 10 years or longer. Most "long-term" assets such as major infrastructure are financed over 25 or 30 years. On the other hand, equipment, which typically has a much shorter economic useful life, is usually financed over an intermediate term of 3 to 10 years.

Fixed and Variable Rate Bonds

Traditionally, municipal bonds have been long-term obligations which bore a fixed interest rate, determined on the basis of the creditworthiness of the municipal issuer. In the past decades, however, more and more municipal issuers have tailored their debt to reflect their specific needs and circumstances or to take maximum advantage of the yield curve to minimize interest expense. Several innovations in municipal finance include variable rate demand obligation, commercial paper and credit enhanced bonds.

Fixed-rate Bonds: Most municipal bonds are issued as fixed-rate bonds, which means that the rate of interest to be paid is "fixed" at the time of issuance and never changes over the life of the bond.

Variable-rate Bonds: In recent years, a significant proportion of municipal bonds have been issued as variable-rate bonds, which do not have a fixed rate of interest. Instead, the interest rate is re-set periodically to match current market conditions, often daily, weekly or monthly. The re-setting can be based upon an index of interest rates, such as a U.S. Treasury Index, Bond Market Association (BMA) Index, or the London Interbank Offered Rate (LIBOR). Using this mechanism, issuers can borrow long term at lower short-term rates if the rate environment is favorable. Key types of variable-rate bonds:

- **Variable-Rate Demand Obligation (VRDO)**: A variable-rate demand obligation (VRDO) is a security for which the interest rate is reset periodically according to a specified index. The bond's demand feature permits the bondholder to require the purchase of the bonds by the issuer or by a specified third party, either periodically, at a certain time prior to maturity, or upon the occurrence of specified events or conditions. This process is often referred to as "putting" a bond or exercising a "tender option." Interest rates generally are based on market conditions and the length of time until the bondholder can exercise the put option. VRDOs typically have a 1-day or 7-day put option where the investor receives the par value plus accrued interest. The minimum denomination is $100,000.

  Almost all VRDOs carry credit enhancement, either a Letter of Credit (LOC), or Stand-by Purchase Agreement (SBPA). The market for VRDOs is large, with many issuers and investors. Issuers include state and local governments and municipal service providers such as water and sewer districts healthcare entities and colleges. Investors include money market funds (VRDOs qualify for purchase under SEC rule 2a-7), corporations, and high net worth individuals

- **Auction Rate Securities (ARS)*:*** Auction Rate Securities (ARS) are long-term, variable-rate bonds tied to short-term interest rates. ARS have a long-term nominal maturity with interest rates reset through a modified Dutch auction process, at predetermined short-term intervals, usually 7, 28, or 35 days. They trade at par and are callable at par on any interest payment date at the option of the issuer. Interest is paid at the current period based on the interest rate determined in the prior auction period. Although

ARS are issued and rated as long-term bonds (20 to 30 years), they are priced and traded as short-term instruments because of the liquidity provided through the interest-rate reset mechanism.

- **Tax-exempt Commercial Paper (TXCP)**: TXCP notes are usually unsecured obligations payable from a specified source of funds. Exempt from SEC registration, TXCP generally matures in a short period of time and usually does not exist for more than 270 days. The average maturity of TXCP is between 30 and 35 days. The average investment is about $100,000, but some investors like TXCP because they are able to negotiate note amounts and maturities that fit their investment objectives and portfolio needs. Major investors in commercial paper include money market mutual funds and commercial bank trust departments. These large institutional investors often prefer the cost savings inherent in using commercial paper instead of traditional bank loans.

  Although commercial paper is occasionally issued as an interest-bearing note, it typically trades at a discount to its par value. In other words, investors usually purchase TXCP below par and then receive its face value at maturity. The discount, or the difference between the purchase price and the face value of the note, is the interest received on the investment. All TXCP interest rates are quoted on a discounted basis.

  One attractive feature is that TXCP notes can generate quick cash; investors pay for notes on the day notes are sold. Another attractive feature is that TXCP interest rates are typically lower than long-term fixed rates. A third attractive feature is simplicity of documentation in that TXCP notes can be sold without an Official Statement or other issuer-prepared disclosure document, although, as explained below, TXCP dealers have been pressing issuers to take responsibility for disclosure.

  Dealers are generally unwilling to undertake a TXCP program unless a minimum amount (say $25 million) of notes will be outstanding. Consequently, smaller borrowers do not have access to the TXCP market and small programs are generally not cost effective.

  In order to undertake a TXCP program, an issuer must have statutory authority to issue notes in an unlimited principal amount and sell notes in a negotiated sale.

How do Interest Rate SWAPs and CAPs Work?

Interest rate swaps are contracts that allow a debt issuer to “swap” the interest rate it currently pays on an outstanding debt issue. For instance, an issuer with variable-rate debt outstanding may want to lock in a fixed-rate of interest. To do this, the issuer enters into a floating-to-fixed rate swap, whereby the issuer will now pay a fixed interest rate. The counterparty to this swap is then obligated to pay a floating rate of interest as determined by some benchmark, such as LIBOR or the BMA Index. Neither the principal nor the actual interest payments change hands. Instead, the net difference between the two interest rates is determined - monthly, semiannually, or annually - and is paid by the party whose payment obligation exceeds that of the other.

Under an interest rate cap, an issuer enters into a contract with a counterparty who, upon receipt of a one-time premium from the bond issuer, agrees to pay the issuer if a specified interest rate index rises above a certain percentage rate, known as the cap or strike rate. The main advantage of caps is the protection they offer against rising interest rates. They can provide an issuer the stability associated with fixed rate debt, while allowing the issuer to take advantage of the lower interest rates often associated with variable rate debt.

Serial Bonds and Term Bonds

There are two approaches to structuring the maturity of bonds. Bonds can either mature annually (serial bonds) or as term bonds.

- **A serial bond** *i*ssue consists of a series of bonds that mature in a regular pattern, usually annually over the entire life of the issue. The interest on each series is paid at regular intervals until that particular bond matures. Serial bonds allow the investor a variety of maturities to fit his or her specific needs. Usually, a single bond issue will consist of a series of bonds with different maturities. The further away the maturity of a bond, generally the higher the risk of the investment and the higher the interest rate associated with the bond.
- **A term bond** is a series of sequential amortizations. Payments of principal prior to the term bond's final maturity are referred to as sinking fund payments. A term bond issue has a single maturity date when the entire principal will be repaid for all the bonds in the issue. A term bond is usually financed through the use of a sinking fund. A sinking fund is a fund into which the issuer makes payments so that when the maturity date of the term bond arrives there will be sufficient funds available to repay the bonds.

Examples:

Maturity Date	Principal	Coupon	Type of Maturity
1/1/2012	10,245,000	1.5%	Serial Maturity
1/1/2013	10,395,000	2.0%	Serial Maturity
1/1/2014	10,605,000	2.5%	Serial Maturity
1/1/2015	10,870,000	5.0%	Serial Maturity
1/1/2016	11,415,000	5.25%	Term Bonds
1/1/2017	12,015,000	5.25%	

What is The Purpose of an Original Issue Discount or Premium?

To more effectively market their bonds, achieve interest cost savings, or meet either financing objectives, issuers sometimes agree to structure their bonds in such a way that the mount of bond proceeds, they receive is either more or less than the principal amount of the bonds

When bonds are sold with an original issue discount (OID), the issuer receives a lower amount of proceeds than the principal it repays. The amount received is generally expressed as a percentage of the par amount of the bonds. For example, if the par amount of the bonds is $100 million and the OID results in the bonds being sold at 99 percent of par, the issuer receives only $99 million in gross proceeds, even though it is obligated to repay $100 million. In exchange for receiving less proceeds, the issuer will pay an interest cost on the bonds that is below the market rate for comparable maturities.

The reverse occurs when bonds are sold at a premium. In this case, the issuer receives more proceeds than the principal amount, but pays a higher rate of interest.

Issuers may choose to sell their bonds with an OID if they can effectively borrow at a lower cost. Issuers with statutory limitations on debt issuance and substantial capital needs may want to limit the use of OID, since they will be giving up bond proceeds that could otherwise be applied to capital projects

Understanding Credit Analysis. What is The Purpose of Credit Ratings and How are They Obtained?

Credit ratings are a source of great concern for state and local officials, since they affect the degree of investor receptivity for a jurisdiction's bonds, and hence, the cost of borrowing. A credit rating provides an easily understandable measure of the degree of risk of an issuer's securities. These ratings are used by investors as a substitute for or to enhance their own research when making a decision on purchasing bonds.

Three major rating agencies provide ratings on municipal bonds. Mood's Investors Service, Standard & Poor's Corporation, and Fitch Investors Service. Long-term bonds of the highest quality are rated "AAA" by Standard & Poor's and Fitch, and "Aaa" by Moody's. Issues rating below "BBB" by Standard & Poor's and Fitch, and "Baa" by Moody's, are considered below investment grade. A separate set of rating symboys is used to evaluate short-term notes.

A issuer will usually request a rating prior to the sale of securities from one or more of three rating agencies. Application for a rating is made a few weeks before the planned sale date. The issuer will submit several types of information, including drafts of bond documents, audited financial reports, and operating and capital budgets. Issuers often decide to make both a written and oral presentation to the rating agencies to help the credit analyst make a more informed evaluation. Ratings are assigned once the analyst has made a recommendation, and ratings committees have acted upon that recommendation.

What Factors are Considered in Reviewing the Credit Quality of Municipal Securities?

In assigning a credit rating, a fundamental concern of the credit analyst is the willingness and ability of the issuer to repay the debt on time and in full. An important part of the rating process will therefore entail a review of the security pledge for the bonds. The revenue source for debt repayment, flow of funds, legal limitations on the pledged revenues, bondholder rights in the event of nonpayment, required reserves, and bond covenants will be carefully examined. The rating agencies will then focus on different types of information, depending on whether the bonds are issued as general obligation, revenue, or short-term securities.

- **General Obligation Bonds.** The credit analyst will focus on four primarily factors:
  - Debt Management. As assessment of the community's ability to support existing and planned debt obligations, using as indicators key financial ratios.
  - Administrative Issue. A review of the organization and powers of the government's administration, and the services for which it is directly responsible.
  - Financial Performance. An analysis of revenue and expenditures trends, and the adequacy, dependability, and scope of revenues.
  - Economic Base. An evaluation of the economic outlook for the jurisdiction, focusing on income population, employment, diversity and composition of employers, and real estate values.
- **Revenue Bonds**. Revenue bond credit analysis entails a review of the same four areas described for general obligation bond analysis. In addition, certain unique characteristics of revenue bonds will be examined. As important consideration is whether or not the service provided by the issuer is and will continue to be demanded by the public, since user fees are often pledged to repay the debt. Review of a feasibility study can be an important component of assessing future demand. The feasibility study

examines economic and demographic trends, reviews historic and projected demands for service, develops a cash flow for the facility, and often compares the costs of providing the current type of service with other alternatives.

Revenue bonds are secured by various legal and financial agreements incorporated into the bond resolution or trust indenture; hence, the credit analyst will carefully review these documents. The rate covenants are of particular interest. These covenants constitute a pledge by the issuer to keep user fees and charges at a level that will cover debt service payments, provide adequate insurance, permit reasonable operation and maintenance of the facility, and ensure adequate reserve funds for capital projects.

- **Short-term Debt**. Credit analysis of short-term debt considers many of the same factors that are used in analysis of long-term debt, although the emphasis may be different. The amount and timing of revenue receipts are particularly important for short-term debt. Issuance patterns will also be examined. Heavy or growing reliance on short-term debt will be viewed with concern by the rating agencies.

What documents do rating agencies need to evaluate tax increment bonds?

Rating agencies need a variety of documents not only to determine ratings at the time of bond issuance, but also to judge whether ratings should be upgraded or downgraded in the future. TIF sponsoring governments have many of these documents on hand, since they are needed to perform their own due diligence. TIF documentation

- City council resolutions or ordinances establishing the TIF district, enacting the TIF plan, and approving TIF bond issuance;
- Agreement or agreements between the governments and developer(s);
- Intergovernmental agreements, such as for revenue sharing;
- Tax collection agreements
- Market studies and or project feasibility studies; and
- Sample tenant leases (e.g., between the developer and anchor tenants).

What is The Purpose of Credit Enhancement?

Credit enhancements generally provide a source of repayment funds that may be relied upon if the primary source of repayment becomes unavailable. Common types of credit enhancement include:

(1) bond insurance, which insures the timely payment of scheduled principal and interest on the bonds,

(2) a letter of credit, which is a standby obligation of a bank to make payments with respect to debt service on bonds if the issuer fails to do so, and

(3) a liquidity facility, which is often used with variable rate issues to provide the issuer the amount necessary to purchase the bonds if the investor exercises the option to "put" the bonds back to the issuer.

Credit enhancement provides added comfort to investors that principal and interest payments will be made on time and in full. Bonds sold with credit enhancement carry the rating of the credit provider. Credit enhancement usually tales the form of either bond insurance of a letter of credit. A letter of credit us typically purchased for a term which is shorter than the life of the bonds; hence, it may have to be renewed periodically at the discretion of the bank. Bond insurance may be purchased for the term of the bonds. In recent years, bond insurance has been generally less costly for tax-exempt issuers than letters of credit.

What Factors Should Be Considered in Determining the final Maturity of the Debt?

The final maturity of a debt issue is determined by the type of project being financed, the financial circumstances of the issuer, and legal constraints on the term of the debt. There are, however, some basic guidelines to follow. Long-term debt should not be issued to fund operating deficits. Short-term (usually less than one year) notes and commercial paper may be used to address cash flow shortfalls between operating expenses and revenue collection.

Long-term debt is appropriate to finance capital projects that will provide benefits over a long period of time. Many issuers structure their debt so that the final maturity approximately corresponds to the useful life of the project being financed. For example, a water treatment plant with an expected service life of 30 years would be financed by a bond issue with a 30-year final maturity; the purchase of a fire truck with a 10 year expected service life would be financed by a bond issue with a 10-year final maturity. Equity considerations should be balanced with credit concerns, which could encourage issuers to retire debt more rapidly.

How can The Maturity Schedule be Designed?

Most governmental issuers of tax-exempt debt sell their bonds as serial bonds, term bonds, or a combination of the two. A serial bond structure is one in which a specific principal amount of bonds retired each year throughout the life of the bonds. A term bonds structure is one in which a large part or all of a bond issue comes due in a single maturity. This large maturity often is attractive to specific investors. Both serial and term bonds pay interest periodically at the coupon interest rate associated with each maturity.

In the past several years, there has been a growing interest in other types of bond structures, such as capital appreciation bonds (CABs). CABs are bonds that do not pay interest periodically; instead, interest accrues until the final maturity of the bonds and is paid un one lump sum.

Additionally, there is an increasing use of derivative products such as interest rate swaps in the tax-exempt market. Although derivative products may make good financial sense for some governmental issuers, there are specific risks associated with their ise. It is important that those risks are understood and studied carefully before an issuer engages in a bond transaction that involves the use of derivative products.

How Can The Debt Service Payments be Structured?

The two most frequently used debt service structures in the tax-exempt market are a level principal maturity schedule and a level total debt service schedule. A level principal schedule retires principal evenly over the life of the bonds, so that total debt service (principal + interest) decreases over time. With a level total debt service schedule approach, early payments primarily cover interest costs, and principal repayment increases over the life of the bonds.

Of course, there are variations to these two approaches. Increasingly, issues are designing the debt service payment schedule such that, when debt service for newly issued bonds is added to existing debt service for outstanding bonds, the combined debt service will take on a specific shape. In the case of construction projects for which the source of debt repayment revenue from the project, principal payments often will be deferred until construction is completed and the facility is producing revenue.

The preceding discussion has assumed issuance of fixed interest securities. At the time of issuing such securities, the issuer knows the exact debt service schedule for the life of the bonds. This is not the case with variable of floating rate securities. Variable rate bonds have maturities as long as 30 years, but the interest rate may be adjusted on a daily, weekly, monthly, semiannual, or yearly basis. A chief advantage of variable rate debt is historically lower interest costs. However, the issuer must accept the risk that short-term rates may rise above the fixed rate it could have received at the time bonds were issued. Consequently, there is less certainly in budgeting debt service payments.

How Does Call Provision Work?

Most sizable tax-exempt bonds contain provisions that allow the issuer to redeem all or a portion of its bonds prior to maturity at specific prices. Issuers frequently want the option to refund previously issued bonds to obtain interest-rate savings in lower interest-rate environments than when the bonds were issued. On the other hand, investors normally prefer the certainty of a fixed maturity with no possibility of a call.

Callable bonds typically will carry a higher interest rate (10 to 50 basis points in the current environment) to offset the risk to the bondholders of having their investment cashed out. Often the bond includes a call protection period of five to ten years after the sale date. During this period, the bonds cannot be called. After the call protection period has expired, the issuer must decide if it is in its best interest to call the debt. Most call provisions require the issuer to pay a call premium to compensate the investor for an early retirement of the debt. The call premium is usually 2 percent to 5 percent above the par value of a bond and will often decrease as the bond ages.

What is A Redemption Provision?

Issuers often structure their bond offering so that they have the right to redeem, or call, outstanding securities prior to their final maturity. An issuer deciding to undertake such a transaction returns the principal amount, accrued interest, and any redemption premium to bondholders. Issuers can structure their long-term bonds to include either mandatory or optional redemption provisions.

A mandatory redemption provision requires that issuers call outstanding bonds according to a schedule which is defined in the official statement. Term bonds are frequently subject to mandatory redemption. In this case, the issuer makes annual payments in the years just prior to the stated maturity of the term bonds. These annual payments, when added to the final maturity principal payment, are sufficient to fully retire the term bonds.

Issuers may also include an optional redemption provision that give them the right to call bonds at their discretion earlier than the stated maturity. The call premium is the price, usually at or above the par value of the bonds, the issuer must pay to exercise this option. The ability to call the bonds away from investors is of particular value to the issuer when interest rates have declined significantly below the coupon interest rates on previously issued, outstanding bonds. The ability to call bonds provides the basis for much of the benefit associated with refinanced (refunding) debt obligations.

Refunding

A substantial amount of long-term debt issuance consists of debt issued to refund other existing outstanding debt. In simple terms, new debt is issued to pay off old debt, normally to achieve cost savings associated with lower interest rates.

A current refunding is a transaction where the outstanding bonds to be refunded are called and paid off within 90 days of the date of issuance of the refunding bonds. There is no federal limitation on the number of current refunding that an issuer may conduct.

In an advance refunding (not allow in tax-exempt bonds), the issuer sells new bonds and places the proceeds into an escrow account. These proceeds, along with the interest earnings that result from their investment, are used to pay off the bonds at their scheduled maturity or first call date (which is more than 90 days after the date of issuance of the refunding bonds).

Arbitrage

Arbitrage in the municipal bond market is the difference in the interest paid on an issuer's tax-exempt bonds and the interest earned by investing the bond proceeds in taxable securities. Proceeds from a bond issue are usually put into short-term investments until either they are spent on their intended use or, in the case of a refunding issue, used to call the original bonds. Both of these situations can generate arbitrage earnings. If interest rates on investments are below the interest rates on the bonds, then there is "negative arbitrage." If interest ra tes on investments are higher than interest on the bonds, then there is "positive" arbitrage.

During the 1980s, the federal government became concerned that municipal governments were abusing their power to issue bonds by issuing bonds unnecessarily in order to try to take advantage of positive arbitrage. The 1986 Tax Reform Act put into place a variety of restrictions and regulations designed to prevent such abuse.

Preparing The Bond Documents- What is The Official Statement (OS)?

The official statement (OS) discloses pertinent information regarding the debt offering of a governmental entity. It is the municipal capital market's version of what is termed an offering circular or prospectus in the corporate capital market. The Municipal Securities Rulemaking Board (MSRB) requires that a copy of the official statement be given to each purchaser of a new debt issue.

The official statement should contain complete information about the bonds being offered including, but not limited to, a description of the security pledged for repayment of the debt, the governmental issuer and its financial condition, the structure of the offering, the risks inherent in owning the bonds, and the legal issues relevant to the issue, especially the tax status of interest income earned by investors.

In a competitive bonds, the official statement and an official notice of the bond sale are distributed to prospective bidders for the bonds. Once the sale is final, the issuer or its financial advisor provide the wining bidder with an addendum reflecting any changes to the official statement.

In a negotiated sale, a preliminary version of the official statement, known as the preliminary official statement (POS), is used by the underwriter to obtain indications of investor interest prior to establishment of interest rates or offering prices. A notice printed on the cover states that POS does not constitute an offer to sale or a solicitation of an offer to buy securities.

What is The Bond Resolution?

The bond resolution is adopted by the issuer's governing body to authorize the issuance and sale of municipal securities. The bond resolution describes the nature of the bond offering, the terms and conditions of the sale, and the obligations of the issuer to the bondholders. Among the provision included in the document are the:

- Amount of the bonds that may be issued;
- Form and maturities of the bonds;
- Security supporting the payment of the bonds;
- Approval of the preliminary official statement and official statement; and approval of the terms of the bond sale to the underwriters.

When a trust indenture is used by the issuer, the bond resolution also approves the trust indenture and provides for the appointment of a trustee who is to act on behalf of the bondholders.

What is The Trust Indenture?

The trust indentures is a legal contract between the issuer and a trustee establishing responsibilities of the issuer and the rights of the bondholders. The trust indenture defines the security, flow of funds, bond covenants, and other provisions for the protection of the investors. The trustee enforces the terms of the trust indenture for the benefit of the investors.

What is The Notice of Sale?

The notice of sale is an advertisement prepared by the issuer to invite municipal underwriters to submit bids for a new debt issue. This document is used when an issuer intends to sell bonds through a competitive bidding process. The notice of sale provides pertinent information about the bond issue, bidding requirements, and date and time of the sale.

The notice of sale must be posted prior to the bid opening date in accordance with state or local statutes. It is usually mailed to all municipal bonds dealers which the issuer or its financial advisor identify as prospective bidders for the bonds. Additionally, the notice of sale is often published in the Bond Buyer, the municipal market's trade journal. Smaller issuers may instead choose to publish the notice of sale in a local newspaper or business journal.

What is The Bond Purchase Agreement?

The bond purchase agreement (also referred to as the contract of purchase or underwriting agreement) outlines the terms, prices, and conditions under which the underwriters agree to purchase the bonds from the issuer. Among the conditions of closing might be a description of any legal opinions to be reinforced on the date of closing and any restrictions or indemnity provisions pertaining to the liability of the issuer. The agreement is normally signed within 48 hours of receipt of the final bid for the sale of bond issue.

The Process of Selling Municipal Bonds (Selecting the Method of Sale)

Most local governments do not have the expertise or resources to find investors for their proposed bond offerings and will require the services of a specialized municipal securities dealer, underwriter or a syndicate of underwriters to sell the bonds for them.

The legally required procedural steps vary widely among the different types of public debt financing. For example, some types of debt require voter approval; some require approval by ordinance subject to referendum; and others may be approved by simple resolution of the governing body of the issuer. Some types of debt require action by official bodies other than the issuer; others need only be approved by the issuer. Nevertheless, much of the process is common to virtually all types of public debt. Broadly speaking, the issuer must undertake the above steps before and after the debt is issued

How Does the Issuer Selecting the Method of Sale?

The decision of how to market municipal bonds should be based on the characteristics of the issuer, the bond issue, and the market. Governmental entities usually issue bonds through competitive bid or a negotiated sale. The goal of an issuer undertaking a bond issue should be the proper administration of the bond issue at the least possible issuance cost and interest rate. Both methods are used frequently in bringing municipal bonds to market. The overriding concern of many issuers is the minimization of interest rates and issuance costs; however, there currently is disagreement in the industry regarding which types of sale results in the lowest costs.

Competitive bidding is appropriate when the issuer is well known, good demand for the bonds is predicted, and the market is stable.

A negotiated sale is more appropriate when the issuer is less known, the market instrument is complex and less well understood by investors, and/or the market is less stable.

What is A Competitive Bond Sales Process?

In a competitive bid sale, the issuer conducts all of the tasks necessary to offer bonds for sale including structuring the maturity schedule, preparing the official statement, verifying legal documents, obtaining a bond rating, securing credit enhancement, if advantageous, and timing the sale. These tasks are normally done with the assistance of outside consultants, including a financial advisor and bond counsel. Once the issue is structured, the public sale begins with the publication of an official notice of sale that delineates the size, maturities, purpose, and structure of the proposed issue, along with instructions for submitting bids.

Underwriters submit closed bids to the issuer on the day and time designated in the official notice of sale. The bonds are awarded to the underwriter that has submitted the best bid, i.e. the lowest true interest cost bid. No structural aspects of the bonds are changed regardless of the success or failure of the underwriter/underwriting syndicate to sell the bonds. Any unsold bonds remain the responsibility of the underwriter.

In a competitive bond sale, the issuer solicits bids from underwriting firms to purchase its bonds, and sells the bonds to the firm or bond syndicate offering the lowest interest cost bid. Two techniques are employed for calculating the interest cost of bids.

Until recently, the bet interest cost (NIC) method of calculating bids was most often used. The NIC is the average interest rate on a bond issue. The NIC method allows for quick calculations, however, it suffers from one important disadvantage. The NIC does not consider the time value of money.

The preferred method of determining effective interest cost is by calculating a bond issue's true interest cost (TIC). The TIC takes into account the time value of money by giving greater weight to earlier debt payments.

With a competitive bond sale, the issuer takes responsibility for preparing bond documents, structuring the issue, obtaining a rating, evaluating the use of bond insurance, and completing all other necessary tasks for the issuance of the bonds prior to soliciting bids. A financial advisor may be employed to assist in these tasks.

What are The Advantages of A Competitive Sale? The competitive process affords the issuer some assurance that bonds are sold at the lowest interest cost given market conditions. Competition provides an incentive for underwriters to submit the most aggressive bid at which they expect to be able to successfully market bonds to investors.

A second advantage of competitive sales of debt is that they have historically resulted in lower gross underwriting spreads relative to negotiated sales. In recent years, however, the difference between negotiated and competitive underwriting spreads has narrowed considerably, so that the cost advantage is not as significant as it once was.

A thirds advantage of the competitive method of sale is that it promotes the appearance of an open, fair process. Taxpayers have greater assurance that bonds have been awarded at the lowest possible cost, and not for the benefit of underwriting firms engaged in political activities to support elected officials.

Are There Disadvantages of a Competitive Sale? One disadvantage of a competitive bond sale is the issuer's loss of flexibility to respond to changes in market conditions. Since the notice of sale must be posted well in advance of the actual sale date, the issuer is also unable to make changes to the issuer's structure to respond to investor demand once the notice of sale is published.

A second disadvantage is that underwriters may build a risk premium into their bids. Because underwriters have no assurance that they will be awarded bonds, they often limit the amount of time spent of the municipal market also encourages underwriters to add a risk premium to their bids.

A final disadvantage is that the issuer has much less control with a competitive sale in determining which underwriting firm is selected and how bonds are distributed among investors. This could be a concern if the issuer is interested in targeting particular types of businesses or investors as a matter of public policy (e.g. to meet Disadvantaged Business Enterprise (DBE) or local preference goals).

What is A Negotiated Bond Sale?

In a negotiated sale, the bond issue is not structured before an underwriter is chosen. If the issuer has not retained a separate financial advisor, the underwriter may assist the issuer in determining what is to be financed, the method of financing and the financing structure. The underwriter is chosen based on expertise, financial resources, compatibility, and experience. After the underwriter is selected, the issuer and the underwriter will begin the process of structuring the bond issue and completing the other origination tasks. The underwriter starts the marketing process and develops an interest rate to be negotiated with the issuer. The issuer often employs a financial advisor not associated with the underwriting firm to represent the issuer's interests in the process.

In a negotiated sale, an underwriting firm is selected early in the bond issuance process before the issuer has full knowledge of the terms of the sale. Once selected, the underwriter will assist the issuer in all tasks necessary to prepare for the bond sale. The issuer negotiates a purchase price for the bonds with the underwriter at the time the bonds are sold.

What are The Advantages of A Negotiated Method of Sale? The negotiated method of sale offers several advantages. First, the issuer can delegate to the underwriter a number of the bond sake tasks (e.g. preparing documents, sizing, and structuring the transaction) which the issuer would otherwise perform itself or hire consultants to undertake.

Because the underwriter known in advance that it will obtain the bonds, a second advantage is that the firm can engage in extensive pr-sale marketing to assess demand for and to promote the issuer's securities. Based on these efforts, a structure can be developed that both meets the needs of investors and is cost effective for the issuer.

A third advantage is the flexibility achieved with a negotiate sale. The structure or timing of the sale can be adjusted as necessary to respond to changing market conditions. This may be particularly important if the financing involves an innovative financing technique or a complicated refunding where savings are sensitive to current interest rates. A negotiated sale also provides the issuer with greater control over the composition of the bond syndicate and the allocation of bonds to syndicate members.

Are These Disadvantages of A Negotiated Sale? Once perceived disadvantage of a negotiated sale is the lack of competition in the pricing of the bonds. As a result, the issuer must make a concerted effort to stay abreast of market conditions to ensure the bonds are priced favorably to the issuer and at levels competitive with the market.

Related to the element of competition above is the difficulty of determining an appropriate gross spread. Because of the variability of gross spreads by issue, it is often difficult for an issuer to assess whether the amount paid for gross spread us reasonable. To a certain extent, these disadvantages can be mitigated by selecting a financial advisor to assist the issuer in the sale process.

A final, important disadvantage of negotiated sales is that they my result in charges of favoritism toward particular firms that are chosen to underwrite the bond issue.

What is A Private Placement?

A private placement is the sake of bonds by an issuer directly to investors without a public offering. Underwriting firms may be actively involved in placing the bonds on behalf of the issuer. Among the reasons that issuers might choose a privae placement area:

- Results in a faster sale process;
- The issue is not rated; or
- Limited disclosure is available or a unique feature or problem must be disclosed.

Private placements of municipal securities are rare, currently representing only about 1 percent of the total volume of bonds issued.

What Factors Should Be Considered in Choosing the Method of Sale?

Issuers must decide which method of sale will result in the lowest cost for their debt and achieve other important policy objectives. This decision should be based on various characteristics of the issuer, the market, and the type of security that is contemplated. It is important to note that a bond issue is not likely to meet all of the conditions that clearly make one method of sale more appropriate relative to the other. The issuer must determine which factors will be most important in marketing its bonds effectively and choose accordingly. Among the factors which an issuer will want to consider are the following:

- ***Credit Quality of The Issuer.*** Investors generally prefer bonds involving less risk, and therefore seek out high-quality issues. For investment grade-rated bonds (e.g., bonds with a rating of Baa/BBB or better), a competitive method of sale can be very effective, all other conditions being equal.
- ***Investor Familiarity With The Issuer***. In the process of deciding which municipal securities to purchase, investors are more likely to consider securities with which they are familiar. Frequent issuers have an established credit history, and little additional effort is needed to enhance investors' understanding of their securities. Therefore, frequent issuers are more likely to be able to successfully sell their bonds in a competitive manner. Governmental entities which are not frequent issuers can benefit from extra marketing efforts associated with a negotiated sale.
- ***Complexity of The Issue***. The more familiar investors are with the debt instrument, structure of the offering, and security for the bonds, the less is the need for a special marketing effort to sell the bonds. Competitive sales are appropriate for types of securities that are commonly issued and widely understood (e.g., general obligation bonds). Bond offering with complex security provisions or innovative structural features require a greater sale effort, and hence, a negotiated method of sale may be more beneficial.
- ***Market Conditions.*** Issuers often choose a negotiated method of sale when financial markets are volatile, In period of abrupt changes in interest rates, it is to the advantage of the issuer to be able to enter the market when rates are at a low point. A negotiated sale provides the necessary flexibility to respond to changing market conditions. The ability to assess market conditions is especially critical when undertaking a refunding, in which the cost-effectiveness of the transaction is dependent on interest rates both in the municipal market and the US Treasury market.

- ***Issue Size***. The municipal market's response to a jurisdiction's bonds is directly related to the size of the offering: the larger the issuer, the more difficulty the municipal market may have in absorbing the bonds. Governments issuing particularly large amounts of bonds may want to consider a negotiated sale.

The Cost of Issuance

Borrowing costs money, in addition to the interest on the amount borrowed. Additional costs include expenses for:

- Bond Counsel Services,
- Publishing Bond Documentation,
- Determining Credit Ratings,
- Trustee/Paying Agent Services,
- Financial Advisor Consulting Fees, and
- Underwriter Commission.

The profits made by underwriters are referred to as the spread. The spread is the difference between the price the underwriter pays the issuer for the bonds and the price the underwriter receives from the resale of those bonds to investors. The spread can be calculated by basis points. One percent of the bond issuance equals 100 basis points. For example, an underwriting spread of 100 basis points or $10 per $1000 bond would equal one percent of the principal amount of the bonds.

For both competitive and negotiated bids, the spread is made up of four separate components: the management fee, expenses, the underwriting fee and the takedown.

- **The Management Fee** -The management fee compensates the underwriters for their efforts in creating and implementing the financing package. The amount of the management fee depends on the complexity of the issuance.
- **Underwriting Fee** -The underwriting fee, also known as the "risk" component of the spread, is designed to compensate the underwriter for the risk incurred by buying the entire issuance before it has received orders from investors for all the bonds.
- **Takedown** -The takedown is usually the largest part of the underwriter's spread. It represents the discount at which the firm or members of the syndicate buy or "take down" bonds from the overall underwriting account. The amount of the takedown depends on how difficult the bond issuance is to sell to investors.
- **Expenses** -The issuer must also reimburse the underwriter for expenses incurred during the development of the financing package and the actual sale of the bonds. The expenses portion represents the physical costs incurred in the course of the bond sale including travel, printing costs, and the underwriter's counsel fees.
- **Bond counsel fees** comprise the next largest portion of the costs of issuance but are a significantly smaller portion compared to the underwriter's spread. Other fees, such as the costs of procuring bond ratings, preparing independent financial audits, and producing disclosure documents, are less than two percent of the total costs.
  Internal costs also add up. Often forgotten and uncounted are the numerous hours incurred by both the executive and the legislative bodies in initiating, analyzing, and approving the borrowing.

The Underwriting Process Steps and Timetable. The following is a general description of the steps and timetable in a typical bond issuance.

Step 1 – Preliminary discussion.

- In a negotiated sale, the issuer starts preliminary discussions with the underwriter, bond counsel, and underwriter's counsel.
- In a competitive sale, the issuer consults with a financial advisor to arrange the bond sale instead of an underwriter.

Bond counsel analyzes applicable local, state and federal laws to determine the extent the financing is affected and what, if any, approvals are necessary.

Step 2 – Issuer adopts resolution stating intention to proceed with a bond financing.

- Underwriter is chosen
- Bond counsel is employed
- Preliminary drafts of bond documentation are produced and reviewed by bond counsel and underwriter (if a negotiated sale). Credit enhancement, if any, is coordinated.

Step 3 – Preliminary Official Statement drafted.

- A draft of the Preliminary Official Statement (POS) is produced and adjustments to the preliminary bond documents are received from the interested parties.
- A series of revisions based on comments from the interested parties are distributed, reviewed and subsequent drafts of the basic documents are circulated. The POS is revised based on the revised documents that have been negotiated and agreed upon by the responsible parties.

Step 4 -Public hearings.

- After a 14-day notice, the issuer initiates a public hearing on the new financing.
- Underwriter (negotiated offering) or financial advisor (competitive sale) distributes POS to prospective investors. Issuer starts printing of bond documents and bond resolution.

Step 5 – Approvals

- The issuer adopts the bond resolution, in which it agrees to sell the bonds to the underwriter, approves the documents and authorizes execution of the bonds.
- The purchase agreement is signed.
- The final Official Statement (OS) is printed. Bond counsel circulates drafts of closing documents. All parties complete and assemble the remaining documents for the closing.

Step 6 -Closing

All documents are executed and delivered. Bond counsel delivers its opinion that the bonds are valid and the interest on them is exempt from federal income taxes. The issuer delivers the bonds to the underwriter, and the underwriter transfers money to the trustee.

Bond Issue Documents. The following are some of the key documents in a bond issuance:

- **Bond/Trust Indenture.** The bond/trust indenture is a contract between a trustee, usually a bank, the bondholders, and the issuer. The bond/trust indenture is the most important of the bond documents and includes the form of the bonds. It establishes the security, interest rate, maturity, bondholder rights and remedies in case of a default. The issuer and the trustee each are bound by the terms of the bond/trust indenture. The issuer promises to pay principal and interest on the bonds. The trustee holds all funds under the bond/trust indenture; pays principal and interest to bondholders; and acts for the bondholders in the event of a default.
- **Official Statement.** The Official Statement (OS) contains the final terms of the bonds. Under federal securities laws, the issuer is obligated to disclose in this document all information that a "reasonable investor" would consider important in deciding whether to purchase a bond. A Preliminarily Official Statement (POS) , complete except for interest rates and maturities, is used to market and pre-sell the bonds.
- **Purchase Contract.** This is the agreement between the issuer and the underwriter in which the issuer agrees to sell the bonds to the underwriter, and the underwriter agrees to purchase the bonds from the issuer at a specified purchase price, typically principal plus accrued interest from the date of the bonds to the date of closing. The purchase contract sets forth the terms and conditions under which the underwriter will purchase the bonds. These provisions include provisions for various documents and opinions to be provided by parties to the financing at the closing, including any expected bond rating.
- **Credit Enhancement Agreement.** In many financings, there may be a credit enhancement agreement that a third party insures or guarantees either the bonds or the issuer's mortgage repayment obligation. Often there are two documents, the guaranty or insurance agreement, which runs to the trustee, and the agreement of the issuer to repay the insurer/guarantor.
- **Disclosure Agreement.** Another common document is the disclosure agreement, in which the issuer, or the borrower in a conduit financing, agrees to provide ongoing disclosure as required by Securities and Exchange Commission Rule 15c2-12.

Documents Requirement in TIF Financing

Because each state statute is different, the name and type of the documents required will be vary.

- **City council resolutions or ordinances** establishing the TIF district, enacting the TIF plan, and approving TIF bond issuance
- **TIF Plan or Redevelopment Plan:** The redevelopment or development plan sets the boundaries for the TIF district, the purpose for the creation of the district, the timeframe for implementation of the plan, the types of development that can occur and other information as required by local law. It is also the vehicle by which the public or community may guage support early on.
- **Development Agreement:** An agreement or contract between the local government (and/or redevelopment authority) and the developer. The contact typically sets forth what will be built, the timeframe for development, the responsibilities of both parties, the amount of tax increment committed by the local government, the responsibilities of both parties, the amount of tax increment committed by the local government and the uses of the tax increment. It may also include requirements for construction guarantees, performance bonds, insurance, Equal Employment Opportunity and other matter associated with a public-private partnerships.

- **Bond Resolution**: The resolution is the document that authorizes the issuance of the bonds, appoints the team and approves all necessary actions associated with the bonds
- **Trust Indenture**: The indenture is a legal agreement between a trustee (a bank), the issuer, and bondholders, events of default, process for redemption of bonds, and certain other items that essentially govern the bonds.
- **Offering Document:** The offering document sometimes referred to as either Official Statement (OS), Limited Offering Memorandum (LOM), Prospectus or Offering Circular is the sole document for marketing the bonds. It explains the transaction, describes the development, enumerates the risks and discloses all essential information regarding the transaction. It is completed when the bonds are issued (settled or closed) and prior to that the team works with a Preliminary Offering Document (or POS, PLOM, etc.)
- **Feasibility Study:** The feasibility study is an analysis by an independent redevelopment consultant that analyzes the revenue stream that will support the bonds. The study is included as an appendix to the Offering Document and debt service on the bonds is sized based on the finding of the study. The study looks at a variety of factors, such as tax rates, assessment practices, payment and collection histories in the area and other factors that can impact the timely receipt of tax increment for the project and payment of debt service on the bonds.
- **Continuing Disclosure Agreement:** The Continuing Disclosure Agreement (CDA) is required by the Securities and Exchange Commission (SEC) as part of a municipal bond transaction. The CDA is essentially a report updating the public and investors on the status of the security for the bonds. It lists certain events that must be disclosed (i.e. missed debt service payment) and usually includes a list of additional information required to be reported on an annual basis. It can be avoided under certain circumstances by law, but most underwriters require it is a matter of practice.

In addition, for tax increment bonds issued after a TIF project is producing revenue – that is, a mature TIF – rating agencies may request annual financial audits or reports issued to state oversight bodies, if applicable.

Disclosure Requirements

The SEC has set forth rules that place regulatory responsibility on the underwriters to ensure that the issuers whose securities are being underwritten have fully committed to provide current and ongoing disclosure of financial details and material events that may impact their ability to meet debt service requirements. They have also given authority to the Municipal Securities Rulemaking Board (MSRB) to write rules related to the conduct of municipal securities dealers and their trading practices

SEC Rules 10b-5 and 15c2-12 provide the general basis for municipal securities disclosure. SEC Rule 10b-5 makes it unlawful for a person to make untrue statements or omit material facts in connection with the purchase or sale of a security. SEC Rule 15c2-12 requires two forms of disclosure: initial (or primary) and continuing (or secondary), unless an issue is exempted.

Initial Disclosure requires the underwriter to obtain the POS and OS from an issuer. In turn, the underwriter is required to send the POS to any potential customer until the OS is available. The OS is required to be sent to customers until 90 days after the underwriting period or, if the OS is available from a nationally recognized municipal securities information repository (NRMSIR), 25 days after the underwriting period.

Continuing Disclosure regulations require the underwriter to obtain a written agreement (the continuing disclosure agreement) from the issuer to provide certain information to each NRMSIR, state information depositories, or, in some cases, the Municipal Securities Rulemaking Board (MSRB). Information to be provided to the market includes, annual financial information or audited financial statements, material event notices (when applicable), and notices of failure to provide annual financial information (also when applicable).

There are 11 defined material events requiring disclosure. They include such major negative occurrences as principal and interest payment delinquencies, non-payment related defaults, unscheduled draws on debt service reserves or credit enhancements, and failure to provide annual financial information as required. There are also a variety of other events, such as bond calls, defeasances, release, substitution, or sale of property securing repayment, and rating changes that are not necessarily negative events.

Material misstatements or omission in the POS, OS, annual financial information, or event notices may be the basis for claims of securities fraud under Rule 10b-5 and other federal or state securities laws. This could result in action taken by the SEC or private plaintiffs (bondholders or other investors) with substantial potential liability for issuers or other obligated persons.

Federal Tax Requirements

Under the Internal Revenue Code of 1986, bonds issued by states and local governmental units generally bear interest that is excluded from gross income for federal income tax purposes. Municipal bonds are taxable if the bonds do not meet the Internal Revenue Code definitions or violate various other prohibitions contained in the tax code. The term "bond" includes any evidence of indebtedness, including notes, installment sale agreements, or financing leases. Although exempt from federal income tax, interest on bonds may be taken into account in determining other federal income tax consequences, such as personal or corporate alternative minimum tax, interest expense deductions, taxation of social security benefits, etc.

In order to be tax exempt, bonds must be issued by or on behalf of a state or a political subdivision of a state. Political subdivisions are public agencies that can independently exercise a substantial amount of one or more of the following governmental powers: eminent domain, police power or taxing power.

Definitions The following definitions are crucial to an understanding of how the tax law applies to public finance.

Bond Issue. In general, federal tax requirements apply to an "issue" of bonds rather than individual bonds. Bonds are part of the same issue if the bonds are sold at substantially the same time (i.e., less than 15 days apart), are reasonably expected to be paid from substantially the same source of funds and are sold pursuant to the same financing plan. Typically, all of the bonds that are sold pursuant to the same Official Statement are part of the same issue.

Bond Proceeds. Just as federal tax rules primarily apply to an issue of bonds, the application of federal tax rules requires an analysis of the investment and ultimate use of the "proceeds" of a bond issue.

Gross Proceeds. Understanding whether funds held by an issuer are "proceeds" at any given time requires an understanding of how funds related to a bond issue are treated as having been spent.

Private Activity Bonds

- If a bond is a "private activity bond," it is not tax-exempt unless it meets the requirements for one of the categories of "qualified" private activity bonds. The requirements are listed below:
- Private Business Use Test
- More than 10 percent of the proceeds of the issue are to be used for any private business use.
- Private Payment or Security Test

The payment of principal or interest on more than 10 percent of the issue is to be secured by or derived from payments in respect of property used for a private business use.

Private Loan Test. Even if the Private Business Tests are not satisfied, an issue will nevertheless be an issue of private activity bonds if the lesser of 5 percent of the proceeds or $5 million are used to make or finance loans to persons other than governmental units.

Volume Cap

In general, the aggregate amount of all tax-exempt qualified private activity bonds issued by all issuers in a state may not exceed the so-called "volume cap." The volume cap for each state is calculated annually and is equal to $50 multiplied by the population of the state.

TEFRA Public Hearing

The Tax and Equity Fiscal Responsibility Act of 1982 (TEFRA) hearing process is a public accountability procedure involving the legislative body of the local agency in which the proposed project is located. During such process, the legislative body conducts a public hearing providing members of the community the opportunity to speak on behalf of or against the nature and location of the proposed project to be financed with tax-exempt bonds.

Rebate Requirement

Generally, the tax code requires that, to the extent gross bond proceeds are invested, on an aggregate, blended basis, in non-purpose investments at a yield in excess of the bond yield, such excess, often referred to as "arbitrage earnings", must be rebated to the federal government.

Simplified rebate example: Bond yield = 6% $100,000 (proceeds invested at 6.5% for 5 years) $32,500 (investment earnings) $30,000 (bond interest) $ 2,500 (rebate to federal government)

Arbitrage Yield Restriction

The tax code generally prohibits municipalities from issuing tax-exempt bonds if the issuer reasonably expects to use the proceeds of such bonds, directly or indirectly:

- To acquire securities or obligations with a yield materially higher than the yield on such bonds, or
- To replace funds used to acquire such higher yielding securities or obligations

Thus, the tax code generally restricts the rate of return on investments purchased with gross bond proceeds to a yield that is not materially higher than the yield on the bonds.

Rebate Exceptions

There are four important exceptions to the rebate requirement that should be carefully considered by the issuer and bond counsel when structuring a bond issue. They are the "Small Issuer Exception" which exempts small issues under $5,000,000 from the rebate requirement and three-time limit exemptions the (Six Month, Eighteen Month and Two-Year Expenditure Exceptions), which allow for an exemption if the proceeds are spent within certain time constraints.

Fair Market Value Rules

One fundamental requirement of all yield related limitations (e.g., the arbitrage yield restriction and the rebate requirement) is that non-purpose investments must be purchased by issuers at a fair market value. Without this fair market value requirement, issuers could simply direct excess profits paid to the federal government to entities other than the United States. The process of purchasing investments at an inflated price, known as "yield burning," has received significant attention and enforcement efforts from federal authorities.

Hedge Bond Restrictions

The tax code generally prohibits tax-exempt bonds from being issued far in advance of the time money is required to construct or acquire the assets to be financed. In general, bonds will be considered "hedge bonds" and will not be tax-exempt unless the issuer reasonably expects either to spend a minimum percent of the proceeds during a defined period of time.

Comply With Arbitrage Regulations

What is the Purpose of the Federal Arbitrage Restriction?

In its application to the tax-exempt market, arbitrage is the difference between the yield on an issuer's tax-exempt bonds and the investment income earned on the proceeds. Arbitrage profits are earned when lower-yielding tax-exempt bond proceeds are invested in higher-yielding taxable securities.

Most state and local governmental entities enjoyed the benefits of issuing tax-exempt obligations. To issuers, tax-exempt obligations provide significant interest rate savings over conventional debt which generates taxable income for investors. To the federal government, the issuance of tax-exempt debt represents the loss of tax revenue because investors do not pay federal income taxes on the interest earned on these securities. Arbitrage restrictions were put in place by the federal government for two primary reasons:

1. to ensure that the proceeds of tax-exempt financings are not solely being used ot make investments in higher-yielding taxable securities, and
2. to ensure that bond proceeds are spent in an expeditious manner

In general, the arbitrage restriction imposed by the federal government prohibit an issuer from retaining arbitrage profits when investing bond proceeds at a yield that exceeds the yield on the bonds. Any excess arbitrage must be rebated to the US Treasury. Certain narrowly defined exceptions to these regulations allow a tax-exempt issuer to retain these earnings if conditions relating to use and expenditure of the proceeds, or amount of issuance are met.

What are The Exceptions?

Tax-exempt issuers may be exempt from the rebate requirement. As of July 1, 1993, the exception allows include the following:

- A small issuer exception for governmental units with taxing authority that expect to issue $5 million or less in tax-exempt debt each calendar year;
- A six-month exception in cases where:
  - bond proceeds are expended for governmental purposes within six months of the issuance date, or
  - proceeds of tax and revenue anticipation notes complying with specific rules are expended within six months;
- An 18-moth exception for bonds issued for governmental purposes where the proceeds will be spend over an 18-month period in a specified manner;

- A two-year exception if at least 75 percent of the proceeds will be used to finance governmental purpose construction projects, and where the construction proceeds will be spent over a two-year period in a specific manner; and
- An exception for bond proceeds invested in tax-exempt securities which are subject to the Alternative minimum Tax.

The regulations pertaining to arbitrage are complicated. Issuers are encouraged to consult advisors to assist in the application of arbitrage regulations to their particular financings. There are strict penalties for noncompliance with the arbitrage rebate rules, including taxability of interest going back to the issuance date of the bonds.

What are General Requirements for Calculating Rebate?

Rebatable arbitrage must be determined and reported at least every five years. Despite this five-year requirement, bond lawyers may require an issuer to compute the amount on a more frequent basis because:

- All bond proceeds may be expended in a shorter time period;
- The rebate amount represents a liability which must be reported in accordance with governmental accounting standards; and
- Annual computations provide security to bondholders that the issuer is complying with the federal regulations.

In addition to the installment computation date required every five years, a final computation made on the date on which the last maturity of the issue is retired. The final installment payment must be made within 60 days after all the bonds have been retired.

The computation of rebatable arbitrage utilizes a future value method. Once the net investment cashflows associated with the issue are determined, they are future valued at the bond yield to calculate the amount of any rebate due

Resources

A significant amount of bond issuance information is available for municipal issuers. Information provided by financial institutions, government organizations, trade groups, educators, along with state and local oversight agencies is available. Through traditional published and electronic Internet sources. The following sources contribute significantly to the understanding of issues related to markets, credit ratings, oversight, and current trends in the industry.

The Bond Market Association. The main trade association representing firms involved in the debt markets.

The Bond Buyer. The daily newspaper serving the municipal bond industry

The Government Finance Officers Association (GFOA). Principal professional association of state and local finance officers in the United States

Electronic Municipal Market Access (EMMA). EMMA is a service of the Municipal Securities Rulemaking Board, which protects investors, state and local governments, and the public interest.

Rating Agencies. The three largest nationally recognized credit rating agencies utilized as sources for credit ratings, research and risk analysis

- Moody's Investor Services
- Standard and Poor's
- Fitch Ratings

Rating Agency Reports

- Tax Increment Debt: Moody's Rating Methodology
- Special Assessment Debt: Moody's Rating Methodology

Kroll Bond Rating Agency (KBRA)

Moody Scale and Definition

Council of Development Finance Agencies (CDFA), resources on TIF and Special Assessments:

- TIF
- Special Assessments
- The CDFA Bond Finance Resource Center

The Municipal Securities Rulemaking Board (MSRB). Makes rules and regulations, along with setting standards for all municipal securities dealers

Internal Revenue Service. Provides information and technical assistance on tax law and requirements

Securities and Exchange Commission. Oversees securities markets, including stock exchanges, broker-dealers, investment advisors, and mutual funds companies

FHWA, Center for Innovative Finance Support:

- Information on Value Capture
- Tax Increment Financing Resources
- Special Assessments Resources

IRS Tax Exempt Bonds

- Post Issuance Compliance
- Tax Exempt Bonds Toolkit

Post-Issuance Policies and Procedures

Rule 15c2-12 Whitepaper April 2016

SEC Adopts Rule Amendments to Improve Municipal Securities Disclosure

Improving Tax Increment Financing (TIF) for Economic Development

Managing the Risks of Tax Increment Financing; Managing-the-Risks-of-Tax-Increment-Financing

Ordinance No. 2439 an Ordinance Authorizing the Issuance of Special Obligation Tax Increment Revenue Bonds (Commerce Drive Project)

Glossary

This glossary provides supplementary definitions which may be useful to an issuer of tax-exempt debt. Terms defined in the main body of the text are not included here.

Accrued Interest – The dollar amount of interest that has accumulated on a security from the most recent interest payment date (or, in some instances, the dated date) up to but nor including the settlement date.

Average Life – Total bond years divided by the total number of bonds (in $1,000 increments).

Basis Point – 1/100 of one percent (e.g. an increase in rates from 8.25% to 8.50% would be a 25 basis point increase).

Bond Year – The product of total number of bonds (in $1,000 increments) and the number of years from the dated date to the maturity date.

Conduit Financing – The issuance of securities by government agency to finance a project of a third party, such as a non-profit organization or other private entity.

Coupon Rate - The annual rate of interest payable on a bond, expressed as a percentage of the principal amount.

Dated Date - The date from which interest begins to accrue on an issue, even though the issue may be delivered on some later date.

Defeasance – Termination of the rights and interest of the bondholder under terms of bond documents

Delivery Date – The date on which securities are delivered in exchange for proceeds. The delivery date is considered the date of issuance for new securities.

Derivative Product – A financial instrument whose own value is based upon the value of other assets or on interest rate levels.

Due Diligence – The process of investing the issuer of municipal securities (often undertaken by underwriter's counsel) to ensure that all material facts related to the sale are fully disclosed.

Future Value – A measure of time value of money – i.e., the amount an investor would receive in the future by investing today at a given interest rate.

Millage – The rate used in calculating property taxes; one mill is equal one-tenth (.1) of one cent or .001 of one dollar.

Net Interest Cost – A common method of computing interest expenses of bond issue, defined as: (total debt service payment + discount (-premium))/Bond years.

Par Value – 100 percent of a security's face value.

Present Value – A measure of the time value of money – i.e., the amount of money an investor would exchange today for a future stream of principal and interest payments.

Sinking Fund - An account into which an issuer makes periodic deposits to assure timely available of monies for the payment of debt service requirements.

True Interest Cost - The rate which, when used to discount totak debt service payments, results in the bond purchase price.

Yield to call – The rate of return earned by the investor from the time of purchase to the call date, assuming the bonds were redeemed at the call price

Yield to Maturity – The rate of return earned by the investor from the time of purchase of the security to its maturity.

U.S. Department of Transportation
Federal Highway Administration

For additional information, please contact:

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