

About Municipal Bonds September 9, 2009

At a Committee of the Whole meeting held earlier this summer, Vince Cainkar, attorney, presented information to the Mayor and Village Board regarding Municipal Bonds. The information has been put into a simple FAQ's for Homer Glen residents.

General Bond Information

1. Compare and contrast a municipal bond to a home mortgage.

- a. Non-recurring costs?
- b. Principal payment?
- c. Interest payment?
- d. Is a bond amortized the same way a home loan is amortized?
- e. What is the term of a bond issue?
- f. Is the interest rate fixed for the term?

ANSWER: A municipal bond is not very similar in structure to a home mortgage. Generally the principal payment schedule on a bond is a maximum of 20 years and most likely in the range of 10 to 15 years. Principal payments are usually due only on December 1 of each calendar year with interest payments due on June 1 and December 1 of each calendar year. Bond may be structured with level debt service (which is similar to amortizing a home loan), but often bonds are structured to take into consideration existing indebtedness and the source of money to pay the principal. If that source increases, then debt service payments are usually set to increase. Bonds can be issued at a fixed rate or a variable rate, or a combination thereof. A typical bond is issued at a fixed rate for the term of the bond and usually subject to redemption (call) after a period of 7 years which allows the bond to be refunded at a lower rate if the market allows. Because variable rate bonds are generally priced off of LIBOR, and LIBOR is at historic lows, many bond issues are being issued at a variable rate to take advantage of low interest rates. Some variable rate bonds are then using swaps to create a fixed rate at a rate less than would be available if the bonds were issued at a fixed rate.

2. What types of municipal bonds are there and how do they compare/contrast to each other?

ANSWER: There are generally two types of municipal bonds: general obligation bonds and revenue bonds. The difference being that general obligation bonds are backed by the full faith and credit of the municipality which has the ability to levy a real estate tax to pay the debt service on the bonds, if necessary. Revenue bonds are payable solely from a specific source of revenue whether it be water revenues, sales tax, motor fuel tax payments, special service area taxes, or TIF District incremental revenues. These types of bonds are not general obligations of the municipality and therefore bear a higher interest rate than a general obligation bond as there is a greater risk on non payment. Many bonds are issued as general obligation bonds but payable from a specific source of revenue so that no tax levy is ever extended, but the municipality enjoys the advantage of a lower interest rate.

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3. What other capital fund raising alternatives exist to issuing bonds and how do they compare/contrast to bonds?

ANSWER: There really are no alternatives to raising capital other than bonds or other types of borrowing such as a note which is pursuant to a bank loan. Actually a bond is just a financial obligation and can be structured in any way that a bank or lender desires.

4. Who actually issues the bonds and how is this party selected?

ANSWER: The actual issuer of the bonds is the municipality. Also involved in the issuance of the bonds is an underwriter, depending upon the size of the bond issue. Typically a bond issue of \$3,000,000 or less can be sold to local banks, but in this economy local banks do not have a large appetite for municipal bonds as they are not making money. If a bond is not sold directly to a bank, then an underwriter is involved. The underwriter prepares the official statement (required by SEC rules) and also works with the municipality with the bond rating agencies. If bond insurance is used, the underwriter works with the bond insurers.

5. What are Build America Bonds and what advantages/disadvantages do they have?

ANSWER: Build America Bonds are taxable municipal bonds which are subsidized by the federal government through an interest payment direct to the municipality over the life of the bonds. Typically a municipality issues tax-exempt bonds to obtain a lower interest rate. Build America Bonds are issued at a higher taxable interest rate, but the municipality receives a subsidy (equal to 35% of the interest payable under the bonds) which lowers the effective interest rate paid by the municipality. These are a new type of bond and typically only issued by very large issuers. 100% of the project proceeds must be used for capital expenditures. The major advantage of a Build America Bond is that there is a broader market because entities which do not pay taxes (such as pension funds, profit sharing plans, and IRA accounts) purchase taxable bonds. These entities would not purchase tax-exempt bonds as the interest rate is too low and they don't pay taxes anyway.

Rates and Bond Issuance

1. What affects the interest rates on bonds?

ANSWER: The length of the maturity, the credit worthiness of the borrower, the rating of the bond rating agencies, and alternative investments. Right now rates on municipal bonds are at their lowest in 15 years because all interest rates are low. There is much skepticism in the market about alternative investments such as stocks, corporate bonds and real estate. However while municipal bond rates are near their lows, the spread between municipal bonds and taxable U.S. Government bonds is very high. Typically a 10-year tax-exempt bond would have an interest rate equal to 80% of a 10-year U.S. Government bond. Today a 10-year tax-exempt bond would likely have a rate of 120% of a 10-year U.S. Government bond.

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2. What is the current rate for municipal bonds, in general, and how does it compare historically?

ANSWER: There is a different rate for every type of municipal bond. There is a general group of bonds called the Bond Buyer GO 20-Year Bond Municipal Bond Index which is an index of highly traded bonds. I have attached a chart showing its history of interest rates. This shows a typical pattern as to the average of tax exempt interest rates and their trend.

3. Detail every step in the process of issuing and retiring bond, from board discussion to payment of the last dollar.

- a. Each individual step
- b. Who is involved in each step
- c. How long each step typically takes

ANSWER: Generally the first step in the issuance of bonds is the need for a capital expenditure. Since a capital expenditure will serve the public for many years, it is only proper that the expenditure be retired over a term of years. Thus a bond would be discussed by the board. The discussion would include how much money is needed, how can it be repaid and over what period of time. If the bond is more than \$3,000,000, then an underwriter would generally be included in the discussion as he can provide charts showing the debt service and probable interest rates. Also involved in the discussion would be a bond counsel who is required to render a legal opinion on the validity of the issue and the tax exempt status of the interest. The first step in recognizing the need and determining the size and maturity of the issue would generally take under 60 days. The underwriter would then prepare the official statement which would be sent to the rating agencies for their rating. This would be 30 to 45 days, especially for a municipality which never had a bond rated in the past. After the rating was obtained a determination would be made by the underwriter as to the availability of insurance and whether it would be cost effective. Generally if a rating were A1 or better insurance would not be required or cost effective. After the rating is received the bonds would then go to sale which would take approximately 7 days. Sometime during this process the bond ordinance would be passed by the municipality setting forth the maturity and rates, or authorizing the mayor to execute a bond order setting forth the details of the bonds. A closing on the bonds would generally occur 21 days after the sale of the bonds although it could occur within 10 days if necessary.

4. Are there any limits on when bond money must be spent after issuance?

ANSWER: This is a very complicated question to answer as there are numerous IRS rules on the expenditure of bond proceeds. Generally if all bond proceeds are spent within 36 months there are no issues. Actually the IRS prohibitions deal with the arbitrage of tax exempt money being invested in taxable investments while awaiting spending. Since the interest rate on taxable investments is actually lower than the interest rate that a municipality will pay on bonds, there is no arbitrage available. Rebate requirements only apply to arbitrage earnings so if a municipality is receiving a lower rate of interest on its investments than it is paying on its bonds, the expenditure of bond proceeds is a moot issue.

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Bond Limits

- 1. Does the amount of bond debt held by the Village at any given time affect the interest rate for new bonds issued? If so, is this a linear relationship from no debt to maximum debt?**

ANSWER: The amount of debt issued by a municipality would have to be overwhelming before it would affect the rating on new bonds and the interest rate thereon. I know of small municipalities which have issued almost \$200,000,000 of general obligation bonds and still maintained an A rating. There is no relationship between the amount of debt and interest rate in most cases. The overriding factor is the ability to pay.

Questions Specific to Homer Glen

- 1. Does Homer Glen currently have a bond rating? If so:**
 - a. What is it currently?
 - b. What will cause it to change?
 - c. How much will it affect our interest rate?

ANSWER: Bond ratings are attached to bond issues and are not given to municipalities in general, although publications seem to imply that a municipality is rated. Since Homer Glen has never issued bonds, none of its bonds have ever been rated. As a practical matter, most bond issues under \$3,000,000 are not rated because those bond issues are sold to local banks and the cost of the rating is an expense. The rating that the Homer Glen bonds receive will be the dominant factor in determining the interest rates on the bonds. My thoughts are that the bonds would probably be rated Moody's A1 or Standard & Poor's AA. These are about the highest ratings that any municipality in southern Cook County or Will County has for its municipal bonds.

- 2. How much, in bonds, can Homer Glen issue and more specifically:**
 - a. What determines the limit?
 - b. What are the constraints as the bond amount increases?
 - c. Are their advantages to splitting up bonds into multiple issues instead of one big bond issue?

ANSWER: As a home rule unit of government there is no limit to the indebtedness of the Village, just as there is no limit to the tax rate of the Village. As a practical matter any bond issue will have to show how the debt service is being paid as that will affect the rating. The market is really the only constraint on the amount of bonds that Homer Glen can issue. As long as a bond issue would be rated A- or better, the market will accept the bonds. I would guess that Homer Glen could issue at least \$50,000,000 of bonds before there would be any concern by the rating agencies. There are no advantages into splitting bonds into multiple issues. The big advantage that the recent legislation in Washington gave to municipalities is to increase the amount of bank qualified obligations which a municipality can issue from \$10,000,000 per year to \$30,000,000 per year for 2009 and 2010. A bank qualified obligation means that a bank can deduct the interest it pays on deposits which are used to purchase tax exempt bonds. Banks only

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buy bank qualified obligations and since banks represent about 30% to 40% of the market, issuing bank qualified obligations reduces the interest rate by about .20% or better.

3. If Homer Glen issues the maximum amount of bonds, do these have to be completely retired before other bonds are issued in the future?

ANSWER: No matter what amount of bonds is issued, Homer Glen can issue additional bonds as long as the rating is acceptable. Most municipalities have at least 5 or 6 bond issues outstanding as bonds would typically be issued every 3 years for capital expenditures.

4. With the amount of sales tax currently forecasted for Homer Glen, how much could we issue in bonds.

ANSWER: At a minimum I would suggest that the debt service coverage for the sales tax be at least 125% since there is no history of sales tax collections.

5. If Homer Glen loses home rule status, will the 1% municipal sales tax be withdrawn?

ANSWER: As long as Homer Glen has issued bonds payable from a home rule tax, the home rule tax would remain in place as otherwise there would be an impairment of the contractual rights and obligations to the bondholders.

6. If Homer Glen issues a bond and loses the 1% municipal sales tax (for any reason), what happens?

ANSWER: If for any reason the 1% municipal sales tax would not be available to pay the debt service, then the Village would have the option to pay the debt service out of other funds, or if none are available then the Village would implement a real estate tax to pay the debt service. When municipal bonds are issued a tax levy is incorporated into the bond ordinance to pay the debt service. As the sales tax money is available, the tax levy for each year is abated so that the County Clerk does not extend the tax levy. If the tax levy is not abated because inadequate sales tax revenues are available for debt service, no abatement is filed and the tax levy is automatically extended by the County Clerk.

7. If Homer Glen issues a bond paid by the 1% municipal sales tax, does this item still appear on residents property tax statements?

ANSWER: If a bond issue is paid by the 1% municipal sales tax, then nothing appears on the property tax bill. The property tax bill only reflects tax levies which are actually extended (and not abated) by the Village. Since the debt service would not be paid by real estate taxes, nothing would appear.

Answers to the questions were provided by Attorney Vincent Cainkar who is a nationally recognized bond counsel listed in the Red Book.