

Institute for Local Government Lawyers

Municipal Finance - It Drives the System

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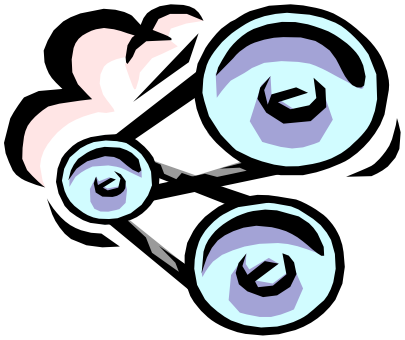
MUNICIPAL FINANCE

IT DRIVES THE SYSTEM

J. Rita McNeil, Esq.

Municipal Finance

The Engine That Drives The System



- ***The "heart and soul", and essence of a municipality, is dependent upon capital.***
- ***The very core of obtaining capital is the issuance of municipal debt and the manner in which municipalities borrow money.***

Why do cities borrow money?

- ***Most municipalities do not have enough cash on hand or short term revenues to meet the community's infrastructure or development needs.***

- ***Therefore, municipal debt financing is often used to purchase or repair high cost items. It is used for capital improvements and for repair and replacement (i.e. street resurfacing and capital facilities improvement).***

- ***Typically, the benefit goes to the public, ensuring a proper public purpose, and the debt must be repaid by the time the improvement wears out.***

Primary forms of municipal debt

- ***General Obligation Bonds**: most commonly used, these bonds typically involve a full faith and credit pledge*

- ***Revenue Bonds**: bonds which are payable only from anticipated revenue; these bonds finance permanent improvements for a proprietary operation (i.e. sewer or water); these bonds are secured by revenues generated by the mortgage of the properties of the system and a franchise (dormant) to operate the system*

- ***Refunding Bonds**: also available, but not as frequently used.*

- ***When a municipality chooses to borrow money, the city acts as the borrower, with the approval of its respective council or commission.***

- ***The purchaser may consist of a variety of entities, including but not limited to, your local bank on behalf of itself; banks or underwriters who buy the debt for resale to others; trust customers; corporations; tax-exempt mutual funds; tax-exempt money market funds or private investors.***



- ***The market for the sale of municipal debt is a highly sophisticated one.***
- ***The market requires information about your city, its financial condition and the particular issue before it will invest.***
- ***This information is distributed through services such as Ohio Municipal Advisory Council ("OMAC"), Moody's Investors Service and Standard & Poor's Corporation.***





Moody's Investors Service

STANDARD
&POOR'S

- ***These entities provide reports on debts to be sold as well as credit ratings for the particular issuers.***

Official Statements

- ***Municipalities must provide a disclosure document known as an Official Statement.***

- ***The Official Statement contains information regarding the municipality and the debt being issued.***

Official Statements

- ***Official statements facilitate the efficient provision of information from issuers to current bondholders, potential purchasers, underwriters, securities analysts, and rating services.***

- ***Official Statements are essential for informed decision making when purchasing securities.***

Official Statements

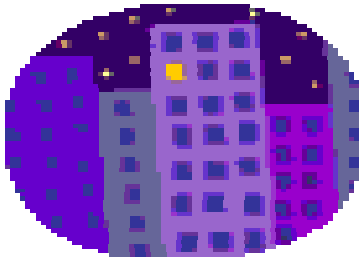
- ***Securities Offered** – OS must describe provisions of the securities*
- ***Credit Enhancement** – if the payment of any principal or interest on the securities is guaranteed or insured by any entity other than the issuer, information about the issuer of the credit enhancement must be provided*
- ***Description of Governmental Issuer** – this section provides general background data and descriptive information about the issuer*
- ***Debt Structure** – this information gives general guidelines for information pertaining to an issuer's debt, which should be included in an OS*
- ***Financial Information** – statements and notes from the issuer's latest audited Comprehensive Annual Financial Report (CAFR) should be included in the OS*

When a municipality sells bonds through a competitive sale, it is imperative that the market knows about the bond sale

- ***In addition to sending bid packets to underwriters, advertisements may be sent to any daily newspaper devoted to news about municipal issues and debt. It is usually a publication very widely read in the municipal debt industry, virtually guaranteeing that municipal underwriters will see the bond sale advertisement by various jurisdictions.***

Bond Counsel

- *The municipal debt process is facilitated with the assistance of bond counsel.*



- *Bond counsel provides issuers with a legal opinion attesting to the validity of bond issues.*

- *Without the approving opinion of recognized bond counsel, the sale of a municipal bond becomes very difficult.*

Bond counsel's opinion provides comfort and information to investors in three areas:

- *That the bonds are legal and binding obligations of the issuer;*
- *The source of payment and/or security for the bonds;*
- *Whether and to what extent interest on the bonds is exempt from federal and state taxes.*

In addition to providing a legal opinion, bond counsel are often asked to provide some or all of the following services for issuers:

- *Assisting in planning the financial structure of the bond issue;*
- *Preparing enabling bond legislation;*
- *Preparing or supervising bond proceedings, including documents necessary to the authorization, issuance sale, and delivery of the bonds;*
- *Obtaining appropriate and necessary rulings, approvals, permissions, and/or exemptions from governmental authorities with respect to the issue*
- *Assisting in the preparation of official statements;*
- *Assisting in presenting information to bond rating organizations*
- *Assisting in other specified activities related to the bonds*

Bond counsel will also render opinions on related matters such as:

- *The applicability of particular provisions of federal and state securities laws;*
- *The applicability of tax law provisions governing estate and gift taxation;*
- *Eligibility of the bonds for investment by various fiduciaries and other regulated investors;*
- *The status of the bonds and related obligations under laws relating creditors' rights; and*
- *The validity and enforceability of security agreements, indentures, and other documents related to the bonds and their security.*

- ***Most municipalities hire a firm to act as bond counsel, and, providing the service is satisfactory, retain the same firm for an indefinite period.***

- ***This arrangement affords the advantage of continuity in the provision of bond counsel services.***

- ***Today, all bonds must be issued in registered form with the name of the owner of each bond being recorded.***

- ***After the bonds are sold, interest and principal payments must be made to these owners as promised by the issuer.***

- ***One way to have this service performed is for the issuer to hire a bank to keep track of the original holders and all subsequent ownership changes, automatically mailing them interest checks from the issuer's funds on interest payment dates. That arrangement will last until the bonds mature.***

- ***This method causes the incurrence of the initial expense of printing bonds and the recurring bank fees charged to make the payments until the bonds mature.***

One common method to issue bonds and notes is in the Bond-Entry Only (BEO) format through the Depository Trust Company (DTC).

- ***The bonds are issued in a fully registered format, with no paper certificates being issued to the ultimate bondholder.***
- ***Instead one global certificate for each maturity is held by DTC.***
- ***There is virtually no printing cost incurred by the issuer.***
- ***Ownership may be transferred only through book entry with bondholders receiving confirmations of ownership.***

Under the BEO system, the issuer does not hire a bank to facilitate payments or other bondholder services.

- ***All such services being performed by banks are performed by DTC at no additional cost to the issuer.***
- ***After the funds to pay bondholders are wired by the issuer to DTC, the issuer has, under federal law, fulfilled its responsibility.***
- ***DTC then pays the bondholders.***
- ***DTC operational costs are borne by its members, the investment and commercial banking industry.***

- ***Use of the BEO method is the most convenient and cost effective way to pay debt service to bondholders.***
- ***A document called a letter of representations is the contract between the BEO issuer and DTC.***
- ***The BEO method must be selected and disclosed before the bonds are issued.***

- ***Bond counsel should be advised of the intent to utilize BEO so that the correct language will be presented in the official statement.***

- ***Finance officials or bond counsel should contact DTC at least a month before the bonds are to be sold.***

- ***Bond counsel will also negotiate the language of the letter of representations.***

CONCLUSION

- ***In conclusion, municipal finance is an integral component of the municipal government system.***
- ***The information provided is only a simplistic glimpse meant to provide a foundation for understanding the finance processes.***
- ***This should at least begin to fuel the engines.***