Financing Options Using Bonds for Illinois Cities and Villages

PART 1

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This is the first of five articles explaining the basics of municipal bonds for Illinois municipalities.

I. WHAT IS A BOND AND WHY WOULD A CITY OR VILLAGE WANT TO ISSUE A BOND

Bonds are a form of debt. In the public sector, "borrowers" or "issuers" of bonds are states, cities, villages, school districts and other local government entities that need money for a variety of reasons. Typically, a borrower will want to issue a bond and pay principal and interest over time to spread out the burden of paying for public infrastructure and assets over their expected useful life, as opposed to increasing taxes or impacting the budget over a shorter term. Such borrowing is highly restricted and must be done in accordance with Illinois law.

II. USE OF BOND PROCEEDS BY A CITY OR VILLAGE

Municipal bonds, or "munis" as they are commonly called, can be issued for a variety of purposes, provided that their issuance accords with Illinois law. Commonly, cities or villages issue municipal bonds for capital projects, working capital needs or refinancing of prior debt.

A. NEW PROJECTS

Generally, a municipality compiles an annual capital improvement budget or prepares a "needs list" or a capital improvement program ("CIP"), spanning a number of years (commonly six years). The CIP consists of projects the municipality considers to be important by means of their impact on the safety, economy and general well-being of the local community. Capital projects can be funded by federal or state grants, local improvement district assessments, service area levies and other miscellaneous revenue available for general purpose use. However, the primary sources of local funding to pay for capital projects are municipal bonds. Projects involving roads, bridges, water facilities, sewer facilities, electrical facilities, municipal buildings or economic development initiatives are examples of projects that are commonly financed with bonds. Thus, generally speaking, if a municipality is building a new capital project, it is likely that the proceeds of a municipal bond issuance are financing the project.

Oftentimes, capital projects are of long-term value to citizens (buildings, roads, land development, parks, etc.). Hence, issuing bonds to fund a capital project allows current and future taxpayers within the community to pay related costs over the life of the project as they avail themselves of the benefits it bestows upon the community.

B. COVERING SHORT-TERM (OR LONG-TERM) NEEDS

Cities or villages can issue bonds to fund working capital expenditures that arise from a variety of circumstances. Traditionally, working capital bonds have been issued as short-term obligations where the proceeds are used to cover an issuer's temporary cash flow, or operating, deficit. Short-term budgetary deficits can arise from a mismatch between the receipt of annual revenues (property taxes or other) and the timing of annual expenditures of the issuer within a year. Tax anticipation warrants ("TAWs") are often issued in anticipation of taxes levied but not yet collected. TAWs may be issued in an amount up to 85% of the total amount levied for the particular fund against which the TAWs are issued. Longer-term working capital bonds have become more commonplace in recent times due to financial difficulties stemming from the recent economic crisis. Municipalities use these longer-term working capital bonds to address structural deficits that are not the result of a mismatch of revenues and expenses. Examples include, insurance reserve bonds, tort judgment funding bonds and working cash fund bonds, which are permitted under Illinois law assuming certain requirements are satisfied. Certain federal income tax issues exist in connection with both short-and long-term working capital financings.

C. REFUNDINGS/REFINANCINGS

Like a homeowner who refinances a mortgage when interest rates drop, a municipality with outstanding debt can issue refunding bonds in order to take advantage of lower rates. Refunding bonds can also be issued to avoid default or restrictive debt burden. A refinancing can be done as a current refunding, which means the old bonds are called or mature within 90 days of the issuance of the refunding bonds, or an advance refunding (limited to one occurrence) where the old

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bonds are called on a specified call date and proceeds of the new refunding bonds are typically held in an escrow account until such later call date at least 90 days after the issuance of the refunding bonds. Refundings generally do not need to satisfy direct or backdoor referendum requirements.

D. SUMMARY OF THE TYPES OF BONDS

Following is a table that briefly describes the most commonly used types of bonds. In the next issue, we will explore these different bonds in more detail.

This article is intended for general information purposes only and does not and is not intended to constitute legal advice. The reader should consult with legal counsel to determine how laws or decisions discussed herein apply to the reader's specific circumstances.

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TABLE OF BOND FINANCING OPTIONS FOR ILLINOIS CITIES AND VILLAGES

TYPE OF DEBT	SECURITY	GENERAL REQUIREMENTS
General Obligation Home Rule	Full faith and credit and backed by the ad valorem taxing power of the Issuer.	Referendum unless exception. No statutory debt limit and no need for voter approval to issue bonds. Flexibility.
General Obligation Non Home Rule	Full faith and credit and backed by the ad valorem taxing power of the Issuer.	Referendum unless exception. Statutory debt limit of 8.625% of E.A.V. required BINA.
Alternate Revenue Bonds	"Double-barreled" – payable from a specific revenue source with the general obligation of the municipality serving as backup security.	Pledged revenues must meet 1.25 times debt service coverage requirement. Backdoor referendum procedures and BINA required.
Debt Certificate	No separate tax levy backing, obligation is a promise to pay by means of budgetary appropriation.	Borrow money by entering into installment contract agreement. Statutory debt limit of 8.625% of E.A.V.
Promissory Note Payable to Financial Institution	No separate tax levy backing, obligation is a promise to pay by means of budgetary appropriation.	Borrow money by entering into promissory note or similar debt instrument. Statutory debt limit of 8.625% of E.A.V.
Revenue	Specific revenue source.	Varies by type of revenue. Referendum and BINA not required.
Special Service Area	Full faith and credit of the taxable real property in the special service area.	Area established with approval of voters/ residents in the special area. Need hearings, notice and various other requirements.
Tax Increment Finance Revenue	Future incremental property tax growth from project, TIF area or contiguous TIF area to repay debt service on the TIF bonds.	Validly created TIF, TIF eligible costs only.
Limited Bonds	Full faith and credit and backed by the ad valorem taxing power of the Issuer.	Payable from debt service extension base unlimited as to rate but limited as to amount.