Municipal Bonds: What Every City Official Should Know

by Steven Pickarski, KLC Municipal Finance Analyst

Building new parks, upgrading utility services, renovating city hall and many more projects may be on your mind and those of your citizens. How will your city be able to afford all the costs associated with the necessary projects and still maintain all services?

By utilizing municipal bonds, cities can issue long-term debt obligations to obtain the required funds to support projects for the public good without having to utilize their cash reserves. This long-term debt approach allows for cities to make projects more affordable and to spread the costs over its reasonable life, so that current and future taxpayers share the costs and benefits of the project. The Kentucky League of Cities Financial Services team wants to ensure you are aware of the types and uses of municipal bonds, and how KLC can help you make your goals a reality.

What Are Municipal Bonds?

Municipal bonds are debt obligations issued by states, cities, counties and other governmental entities. The purpose is to fund a public project such as bridges, sewers and schools. By issuing a bond, the city has committed itself to pay bondholders principal, the original investment amount, plus interest over the life of the bond. With this commitment, the city is given immediate access to the requested funds.

An added benefit to bondholders outside of interest payments is the fact that the interest income paid to the bondholders is typically exempt from federal income and potentially state and local taxes. By offering these incentives, municipal bonds will often carry an interest rate lower than taxable bonds. This lowered interest rate means that it is less expensive for cities to borrow money.

The Securities Industry and Financial Markets Association reports that from 2005 to 2017, Kentucky has issued more than $169 billion in municipal securities. This averages out to $13 billion per year.

Types of Municipal Bonds

There are two primary types of municipal bonds — general obligation and revenue bonds.

A general obligation bond is supported by the full faith and credit of the issuing city. The bond is secured by the taxing power of the city. With this approach to financing, these bonds are viewed as the strongest credit in the eyes of credit rating agencies, since a bondholder can require the collection of taxes to pay the outstanding debt.

In Kentucky, the ability to issue general obligation bonds was limited by the Kentucky Constitution until 1994. Prior to this date, a city was required to obtain a two-thirds approval from the voting public before obtaining any additional debt that could not be repaid within one year. This requirement was removed with an amendment to Section 157; cities can now issue general obligation debt as long as the city has an annual budget where expenditures do not exceed revenues. According to Section 157b, expenditures associated with municipal bonds are defined as the principal and interest payments that come due during the fiscal year. In addition to this requirement, Section 158 goes further by limiting the total amount of general obligation debt a city may issue based on its population. These specific limits only apply to obligations or bonds as set forth in Kentucky Revised Statutes (KRS) Chapter 66.

With these regulations, cities and other municipalities across Kentucky have used KLC to help them finance various projects. In 2018, KLC helped cities obtain financing for a library expansion, new fire hydrants, land purchases, a new gymnasium and a new city park.

A revenue bond, unlike a general obligation bond, is not backed by the full faith and credit of the issuer. Revenue bonds are secured by the stream of revenue generated by the project. These bonds were more commonly issued prior to the amendment of the Kentucky Constitution to navigate around the voting requirement. The obligation may include additional language to stipulate the minimum rate and/or charges required to fulfill the payments associated with the bond. The uncertainty of this revenue can cause the overall cost of borrowing to be higher due to investors seeking a higher interest payout for the additional risk. Unlike general obligation bonds, there is no specified maximum for total indebtedness in relation to a city's population. A revenue bond is excluded from that calculation pursuant to KRS Chapter 66.031.

Kentucky cities have issued revenue bonds through KLC to pay for improvements to water and sewer facilities to conduct energy savings projects and to refinance existing revenue bonds at a lower rate.

KLC Services

How do you know when to use which KLC Finance program? How do you determine how much you can borrow? Who handles all steps in the process to get the bonds sold? That is where KLC Financial Services comes into play.

GENERAL OBLIGATION BOND: Supported by the full faith and credit of the issuing city

REVENUE BOND: Secured by the stream of revenue generated by the project

Since 1987, KLC has helped cities access more than $1.5 billion in financing. By cultivating an experienced internal and external team, KLC is a one-stop shop for your needs. KLC will work directly with city officials to help obtain the necessary funding for a project. KLC tailors its program to fit the unique needs of each project. KLC works with bond counsel and municipal financial advisors to provide the necessary financial documents that outline the total cost to borrow for the life of the bond. The KLC Finance team is available to present to city stakeholders, to answer any questions and to clarify the steps in the process. As the project progresses, the city will be provided with all necessary ordinances, resolutions and agreements. To get the process started, the city provides a brief application outlining the potential funding need and a recent audited financial statement. KLC's goal is to make the process as painless as possible for the city to achieve its goals. The ease and simplicity of KLC's Finance programs is proven by the repeat business. In the Kentucky Bond Corporation pool alone, over half of the borrowers use the program multiple times to issue long-term debt. Contact KLC at 800.876.4552 to see if municipal bonds or our other services are a fit for your city's next project.

KLC BOND DEAL WORKFLOW

We make it easy

1. City shares application and audits

2. City receives preliminary financing costs

3. Legislative documents provided to city

4. City completes and returns legislative documents

5. KLC Finance Team organizes all completed documents

6. KLC Finance Team conducts bond sale

7. KLC sets up trustee accounts for city

8. KLC has funds disbursed to city, as requested

9. City shares annual audits with KLC

10. KLC administers the program and completes all federal requirements for disclosure