FOX POINT *files*

by Douglas H. Frazer

The Secret Life of Municipal Bonds

The Village of Fox Point budget stands around $7 million per annum and is generally divided between operating (current) and capital (long-term) expenses. Operating expenses would include employee wages and other regular expenditures whereas capital expenses include such things as the purchase of equipment or street repair. The village largely funds operating expenses through the current year levy (taxes) and capital expenses through borrowing repaid with future levies. The village borrows principally through the issuance of municipal bonds.

A bond is a debt obligation: an investor loans money to an entity for a defined period of time at a variable or fixed interest rate. Bonds are used by companies, municipalities, states and sovereign governments to raise money and finance a variety of projects and activities.

A municipal bond is issued by a unit of government below the federal level, including states, counties, cities, villages, redevelopment agencies, special-purpose districts, school districts, public utility districts, or any other government entity having the power of taxation, eminent domain, or police power.

Municipal bonds may be general obligations or secured by specific revenues.

The City of New York issued the first municipal bond in 1812, a general obligation bond, for the construction of a canal.

The Village of Fox Point issues only general obligation bonds typically in denominations of $5,000 or multiples thereof, paying principal and interest on a schedule. The instruments mature serially over the course of the loan term.

Municipal bonds have an attractive feature to most lenders. The interest income is generally excluded from gross income for federal income tax purposes. [26 U.S.C. § 103]

Borrowing for capital expenses makes sense for several reasons. It permits the matching of tax payments, which fund the debt service, to the user of village improvements. For instance, if the levy funded capital expenditures directly for a street repair with a 20 year useful life then a property owner who moved out of the village after five years would have paid for 15 years' worth of the cost without a benefit. Moreover, borrowing can be a relatively inexpensive way to fund capital costs: bond buyers are willing to accept a reduced interest rate because the bonds are tax exempt and low risk.

The rules for municipal borrowing are contained in Chapter 67 of the Wisconsin Statutes. Prior to the issuance of a bond, a municipality must adopt a resolution that states the maximum amount to be borrowed and the public purpose. Once accomplished, preparations are made for issuance. The Village of Fox Point uses Baird as its financial advisor and Whyte Hirschboeck Dudek S.C. as bond counsel. Baird prepares an official statement concerning the bond issuance, obtains a bond rating, and takes the bond to market. Bond counsel prepares and reviews the legal documents and issues an "opinion letter" that all is legally in order. Then the village board passes an "award resolution" that finalizes the terms and interest rate, and approves loan-related documents. The closing occurs and the purchaser makes the funds available to the village.

Most village-issued municipal obligations have a 10-20 year term and typically contain a "call" provision meaning the village cannot redeem (pay the obligations off early) before a certain date.

The Village of Fox Point went through this procedure in fall 2015 issuing obligations in the amount of $3,265,000 with a final maturity date of April 1, 2025, and an interest rate at 1.38%. It designated $975,000 of that amount for public projects and the $2,290,000 balance to pay off early certain bonds the village issued in 2006 at a higher interest rate. In the world of municipal bonds, this procedure is called "advanced refunding." By taking advantage of the village's superior Aa1bond rating (Moodys) and the current low interest rate environment, the village saved $122,451.

Since 2005, the State has reserved the right to impose limits on the growth of municipal levies. Exempted (with restrictions) from the levy limit calculation, however, is debt service. [Wis. Stat. § 67.035] Thus, while levy limits are in place, municipal borrowing is an especially important tool for funding capital expenditures while concurrently paying for operating costs and maintaining current service levels.

Municipal bonds have further state-imposed restrictions. For instance, the village must spend the money for the stated purpose within a relatively short window of time. Also, the funds may not be used for arbitrage purposes, which are investing the funds to obtain a higher rate of return than the interest rate it is paying out on the bonds.

Municipal borrowing finances our infrastructure, including roads, bridges, and other public works-related projects. Fox Point benefits from the federal tax exemption on the interest cost of the borrowed money, a benefit that the board passes on to property owners through lower levy rates and greater investment in infrastructure. In addition to taxes, fees, state aid, and federal grants, borrowing is a useful—possibly essential—funding source that gives us the means to apportion costs fairly and make our budget work.

Douglas H. Frazer is a trustee on the Fox Point Village board. The views expressed are his own and not necessarily those of the village, the village board, other village board members, or Best Version Media, LLC.

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