

PROVIDING DIRECTION
PRODUCING RESULTS

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Some Intelligent BABling

Build America Bonds (BABs) were the “big thing” for public finance in 2009. Consider the following results reported by *The Bond Buyer*:

- More than \$64 billion in BABs were issued in 2009.
- BABs significantly increased the use of taxable bonds. One-fifth of all municipal debt issuance (\$84.47 billion) was in the form of taxable bonds. This market share is double the next highest year (10.7% in 2003).
- Issuance of tax-exempt bonds fell by 5.3% in 2009.

If you issued bonds in 2009 or plan to issue in 2010, BABs should be on your planning checklist. Here are some things you need to know.

Requesting Payment

BABs allow issuers to receive federal payment equal to 35% of the interest expense. The payment is not automatic and must be requested by the issuer. Issuers must submit IRS Form 8038-CP to request an

interest subsidy payment. Form 8038-CP was revised in January 2010. This form can be found at <http://www.irs.gov/pub/irs-pdf/f8038cp.pdf>. The new form allows for direct deposit of subsidy payments. An electronic payment system is under development.

It is important to understand the timing connected with the subsidy payments. To ensure timely payment, the Form 3038-CP should be filed no later than 45 days prior to the interest payment date. The Form may not be filed more than 90 days in advance.

Compliance Check Questionnaire

The IRS has started collecting information on “the post-issuance and record retention policies, procedures and practices of issuers of Direct Pay Build America Bonds”. This information is being collected through Form 14127 – “Direct Pay Bonds Compliance Check Questionnaire”. Distribution of this Form began in early February and will continue on an ongoing basis.

Pay close attention to the cover letter that accompanies the Form. The top right section of the

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Refunding Review

With the exception of a large hiccup in 2008 and 2009, long-term tax-exempt interest rates have followed a consistent pattern. Rates have been a roller coaster of peaks and valleys (see chart on right). These valleys create opportunities to refinance existing debt. In these times of limited financial resources, it has never been more important to make the most effective use of the savings from refinancing. This is a good time for a brief refresher course on the ins and outs of refunding.

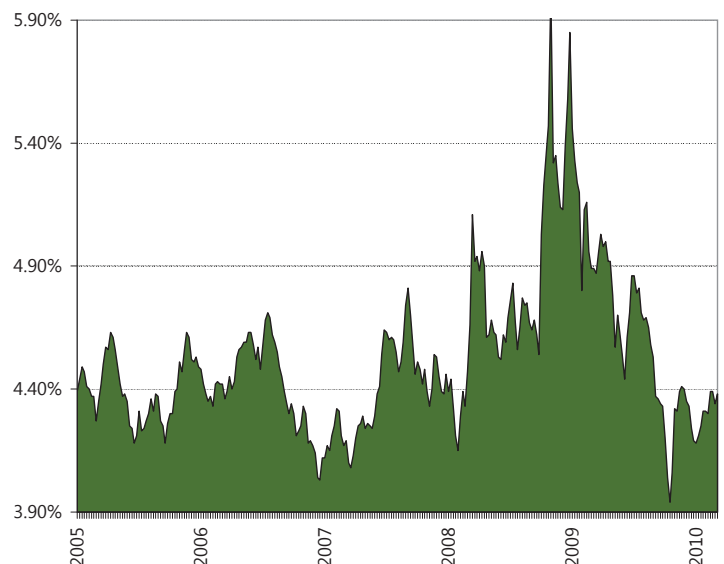
Basic Terms

Before discussing the intricacies of refunding, some basic terms need to be defined.

- **Call Date.** Unlike your home mortgage, municipal bonds cannot be prepaid at any time. As part of the original offering terms, the issuer sets a “call date”. This is the first opportunity to prepay outstanding principal, calling bonds back from the investor.
- **Advance Refunding.** Just because the call date occurs in the future does not mean that the issuer must wait before refinancing. An advance refunding allows the issuer to issue refunding bonds

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Housing Improvement Areas

Alright, raise your hand if you have heard of a "housing improvement area"? Not too many hands in the air. The housing improvement area (HIA) may be one of the most overlooked tools available to Minnesota cities. The HIA allows cities to partner with residents and homeowners' associations to undertake critical reinvestment in buildings and infrastructure. With the boom in townhome construction during the past decade and with a large supply of 20 and 30 year old condominiums, the potential use of this tool will grow. This article explains the function and application of housing improvement areas.

The Need

Before examining the HIA, let's consider the need. The single-family (detached) house and the apartment building are owned by a single party. This single party owns the entire building and site and is solely responsible for its maintenance. Residents of townhomes and condominiums face some unique challenges in undertaking property maintenance. The interior of the housing unit is owned by the individual homeowner. The shell of each building and all infrastructure are common property, owned jointly by all homeowners. The maintenance and revitalization of the common property is the shared responsibility of the homeowner's association, guided by a board of directors. Association members pay monthly dues to fund current and long-term maintenance. With proper planning and financial management, an association accumulates reserves needed to undertake major capital replacement projects. Problems arise when an association fails to plan for the future.

Associations may find themselves financially handcuffed. Bylaws typically set limits on a board's ability to increase dues or levy special assessments without approval of homeowners, often with thresholds exceeding simple majority. These are the only revenues available to an association. Even with homeowner support to raise revenue, an underfunded association may not be able to catch up. Acceptable annual revenues may not provide the resources needed to undertake capital improvements. The lack of capital reserves may lead to a continuing downward spiral of deteriorating physical condition of the housing. Over time, the lack of investment leads to the loss of value for owners and taxing jurisdictions and the diminished ability to sell units.

The HIA is a means for cities, homeowners'

associations and property owners to create a collaborative solution. In simplest terms, a housing improvement area is a special taxing district used to make improvements in areas of owner-occupied housing. To pay for these improvements, a city may levy "fees" and issue bonds.

It is not possible to describe all of the details and nuances of housing improvement areas in the confines of this article. The following sections highlight the basic elements of the HIA.

Enabling Actions

An ordinance defines the boundaries of the area and the improvements that can be undertaken. The HIA Statute does not define (or limit) the improvements that can be made through a HIA. Any improvement to the common property of association can be done through a HIA. Potential uses include rehabilitation of streets, garages, roofs, windows and HVAC.

A resolution sets the parameters of the fee. The fee is the mechanism for collecting revenues from property in the improvement area. The resolution defines the term of the fee and how it is allocated to properties. A fee may function like a property tax, distributed on the basis of tax capacity value of property in the area. Other allocation methods include equal amount by housing unit and pro-rata share of ownership interest. A city may also assess housing improvements to benefitted property within an area. The resolution also sets the means of collecting revenues. HIA fees may be collected through the property tax system or through other means provided by the City.

Process

Use of these powers is subject to unique procedures. A city council has the power to initiate use of most municipal finance tools. The procedures to establish the area and to levy the fee must begin with a petition of property owners. Owners of 25% or more of the housing units that would be subject to the fee must petition the city to hold a public hearing on the area and on the proposed fee.

City actions to adopt the area ordinance and the fee resolution are also subject to veto by property owners. Residents of 35% or more of the housing units subject to the fee may file an objection to the ordinance and block its adoption. Adoption of the fee resolution is blocked if the owners of 35% or more of the housing units' tax capacity subject to the fee file an objection. Objections must be filed before the effective date of the ordinance or

Minnesota cities gained the authority to establish housing improvement areas in 1996. The statutes governing the use of HIA are found in Minnesota Statutes, sections 428A.11 to 428A.21 (the HIA Statutes). The HIA Statutes are currently scheduled to sunset on June 30, 2013.

the resolution. The effective date cannot be less than 45 days after adoption by the city council.

Bonds

The HIA Statute authorizes the issuance of bonds to finance authorized housing improvements. These bonds may be general obligations of the City. General obligation housing improvement area bonds do not require an election and are not subject to the debt limit. The bonds are payable primarily out of the proceeds of the fees or from any other special assessments or revenues available to be pledged for their payment under charter or statutory authority, or from two or more of those sources. The bonds cannot be issued until after a contract for the construction of all or part of the improvements has been entered into or the work has been ordered.

Jurisdiction

A city is the only political subdivision authorized to establish housing improvement areas. Once the area is established, the city may assign implementation powers and responsibilities to another entity. An economic development authority, housing and redevelopment authority or other entity authorized by law to exercise their powers may be designated in the enabling ordinance as responsible for implementing and administering the housing improvement area. This action conveys the powers to make and finance improvements in the HIA.

Tips

Past experience with the use of housing improvement areas offers several suggestions on making use of this authority.

City/Association Relationship. In a perfect world, cities would not need to establish housing improvement areas. Homeowners' associations would adequately finance the maintenance of common ownership elements. A proactive role in building relationships with associations may reduce the need for HIA.

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Refunding Review from Page 1

and lock in low rates prior to the Call Date. The proceeds of the new, refunding bonds are set aside and used to prepay the existing bonds on the call date. Some different types of advance refunding are described below.

- **Refunding Escrow.** The proceeds of an advance refunding bond are placed in an escrow account. Monies in the Refunding Escrow are used to retire existing debt on the Call Date. Depending on the type of refunding, money in the Refunding Escrow is also used to pay debt service on the refunding or the refunded bonds. The ability to invest monies in the refunding escrow is an important factor in the economics of refunding.

Types of Refundings

There are several basic types of refundings and it is important to know the characteristics of each.

The most economically efficient option is the **Crossover Refunding**. This refunding only refinances the principal maturing after the call date. The monies in the Refunding Escrow are used to pay interest on the refunding (new) bonds until the Call Date and then "crossover" to pay off the existing bonds at the Call Date. The issuer continues to pay on the existing debt until the Call Date and then crosses over to begin paying on the lower cost refunding bonds.

The Crossover Refunding typically produces the greatest amount of total savings. Issuers should note that the savings do not occur until after the Call Date.

It is possible to create immediate savings from an advance refunding. A **Full Net Defeasance Refunding** effectively takes existing debt off of the books (as of the closing date for the refunding). The advance refunding bonds borrow enough money to fund the Refunding Escrow at a level that will pay all interest and principal on the existing bonds prior to the Call Date as well as prepay the outstanding principal on the Call Date. Since the existing bonds are "defeased" the issuer immediately begins to pay on the new, lower rate refunding bonds.

Not all refundings occur prior to the Call Date. A **Current Refunding** can be used if the bonds are at or after the earliest Call Date. No Refunding Escrow is needed for a Current Refunding. Bond proceeds are immediately used to call and prepay existing debt.

Evaluating the Opportunity

Issuers should remember that every issue of governmental purpose tax-exempt bonds is eligible for a single advance refunding. Careful planning and evaluation will help make the most of this opportunity. Here are some factors to consider in planning for the issuance of advance refunding bonds.

Market Risk. Every refunding decision is a balancing act between locking in savings and future market conditions that may produce more savings. This evaluation is influenced by the amount of time to the first Call Date. The further away the Call Date, the more chances for market conditions that produce acceptable savings.

Negative Arbitrage. Low investment rates reduce the efficiency of the Refunding Escrow. Low investment income requires issuing more refunding bonds to properly fund the Refunding Escrow. Adding refunding bonds reduces the amount of savings. Improved investment rates and a shorter period to the Call Date help to reduce Negative Arbitrage.

Use of Cash. Some types of debt build up balances in the debt service fund that can (or must) be used to call bonds and reduce the overall debt. Bonds for public improvements, for example, often receive prepaid assessments.

Restructuring. Refundings creates the opportunity to review and evaluate changes in the debt structure. Some restructuring considerations include:

- Altering principal payments to better match dedicated revenues.
- Adjusting savings to free up revenues for other capital projects.
- Extending debt to reduce annual impacts.

Using a "Trigger"

Refunding opportunities come and go quickly with constantly changing bond and investment rates. In this environment, a competitive sale may not be the best means to achieve your primary objective - maximize savings. A competitive sale sets a fixed sale date, often 4-6 weeks after you first become aware of the refunding opportunity. The competitive sale may produce the lowest rates at a given time, but the window of low rates that started the process may have passed. Look at the chart on Page 1. Few of the low rate periods last for the 4-6 weeks required for the typical competitive sale process.

A more flexible option for refundings is the use of a trigger resolution and the negotiated sale of bonds. The trigger approach uses a

minimum savings threshold, not a fixed sale date, as the criteria for a refunding.

The governing body adopts a trigger resolution that authorizes specific officials to accept a bond purchase agreement when stated savings (and other potential criteria) can be achieved. The agreement is subsequently ratified by the governing body at its next meeting.

The resolution creates the flexibility to sell refunding bonds when conditions merit rather than waiting for a scheduled meeting.

Draft sale documents and rating materials are prepared in advance. This preparation greatly reduces the time needed from concept to sale.

A negotiated sale enhances the ability of the trigger approach to maximize savings.

Bond traders often see the signs of improving market conditions before bonds sales attract lower rates. Getting to the market early may avoid the rate rebound that often comes with increased supply.

The ability to adjust the structure of the refunding bonds and the escrow to respond to changing market conditions is paramount with an advance refunding. The opportunity to realize savings is determined by the interest rate on the new refunding bonds and the investment rate for the Refunding Escrow. Market flexibility allows the issuer to maximize both sides of the equation.

In a negotiated sale, the underwriter engages in pre-sale marketing activities to assess investor interest in an issue, as well as demand for certain structures or maturities. Pre-selling of the bonds creates competition among the investors, enhancing the issuer's position resulting in aggressive or low interest rates. The issuer also has the ability to react to this market response and alter terms of the issue that increase savings without damaging basic financial objectives.

The negotiated sale allows the issuer to shift timing to achieve the best results. A competitive sale is all or nothing at the fixed time to bid. The negotiated sale can extend pricing for days or simply restart weeks later until the savings target is met.

Conclusion

Refunding existing debt is an important part of the financial management tool kit. With one chance to perform an advance refunding it is essential that issuers clearly understand the issues associated with refunding. Define your objectives for refunding and create a process for issuing the bonds that achieves the best results.

BABs from Page 1

cover letter includes the response due date for the Form. We strongly encourage you to promptly complete and return the Compliance Check Questionnaire. It is likely that you will have questions about the appropriate responses to Form 14127. Do not hesitate to contact your bond counsel or financial advisor with your questions.

Points to Remember

While simple in concept, the use of BABs is subject to some requirements not part of your typical tax-exempt bond issues.

- Bond proceeds may not pay for costs of issuance exceeding 2% of the bonds.
- The issue cannot include capitalized interest beyond the date the improvements are placed in service.
- In addition, only 65% of needed capitalized interest can be included in the issue since federal reimbursement will cover the other 35%.
- The terms of sale must include specific restrictions on the ability to reoffer the bonds at a premium.
- Issues should contain an "extraordinary call" provision that allows the issuer to immediately call and prepay all outstanding principal in the event that, for any reason, the issue becomes ineligible as a BAB or the federal government no longer provides the subsidy. Taxable BABs may be refunded with tax-exempt bonds.

Market Conditions

The economics of BABs varies over time with changes in taxable and tax-exempt interest rates. The chart on this page shows sample general obligation interest rates for the week of March 5. Issuers should make some form of market check a part of the sale process. For competitive sales, bidders should be able to submit taxable BABs and tax-exempt bids. For negotiated sales, a pre-pricing comparison of BABs and tax-exempt should be performed. These steps help the issuer to be assured that the sale will achieve the lowest effective interest expense.

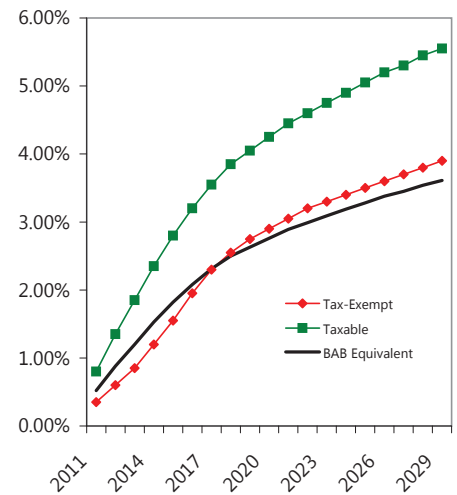
Looking Ahead

The *current* authorization for the issuance of BABs ends on December 31, 2010. There appears to be growing support for extending the BAB program.

Extension does not mean that the program will be the same. One area of discussion is the amount of the subsidy rate for future BABs. The Administration's FY 2011 budget proposed dropping the rate to 28%. There does not appear to be congressional support for a drastic change in the subsidy rate. At some point, a reduction in interest subsidy eliminates the economic advantage of BABs over tax-exempt bonds.

Extension of the BABs may also come with new procedures on the issuance and management of these bonds. The contents of the Compliance

Average Rates (March 5, 2010)



Data compiled by Northland Securities

Check Questionnaire suggest some potential areas of interest to the IRS.

Interest subsidy and direct payment options are being explored as alternatives to tax credit programs. Few issuers have used the option to issue the current version of BABs as tax credit bonds.

Housing Improvement Areas from Page 2

Education and Consensus. The key to success is the time spent on the front end to understand needs, explore alternatives and build support for a plan of action. The petition and veto provisions require a collaborative approach to finding solutions.

Limited Prepayment. Give careful thought to granting the ability of property owners to prepay the fee. The ability to prepay makes the fee function like a special assessment. Banks may require prepayment upon sale of the unit. If the fees are pledged to bonds, the city may face negative arbitrage from the inability to invest the prepayments at a rate equal to the bonds. Finally, prepayment creates administrative headaches because the implementing entity must keep amortization schedules for every housing unit. A good

compromise is to allow a one-time prepayment period immediately after the fee is approved.

Lasting Solution. Use of a HIA should be a one-time fix and not an ongoing capital funding plan. Associations must create long-term capital improvement plans including the dues, assessments and other monies needed to pay for the improvements. Cities should have an ongoing program for monitoring these plans and the financial condition of the association.

Build a Reserve. The traditional way of building a debt service reserve is to borrow money in the bond issue. Another approach is to delay payment of principal for one year (or longer). Paying interest only allows for an accumulation of fee revenues to provide protection against future delinquencies.

Conclusion

With the growing number of aging common ownership neighborhoods in every community, the chances are good that some will experience physical and financial distress. Cities should understand the basic elements of the housing improvement area as a tool for meeting community housing needs.

The information in this newsletter is based on sources believed to be reliable, but does not purport to be complete and is not warranted by Northland Securities, Inc.

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