Ohio Land Bank Conference 2014

Alternate Strategies for Funding Demolition

September 11, 2014

With nearly 100,000 homes awaiting demolition in Ohio alone, demolition funding is a priority for all local government officials. This session will present two strategies for demolition funding - - county issuance of demolition bonds and tax increment financing. The discussion will involve the details of structuring an Ohio county issuance of bonds for demolition, as well as the option of the creation of a tax increment financing program for funding of land bank activities, including demolition and rehabilitation.

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Session Agenda

I. Property Valuations

II. Legal / Financial Considerations Surrounding Demolition Funding

   A. State Law Issues

   B. Federal Tax Issues

III. Credit / Alternative Structures:

   A. Sales Tax Revenue

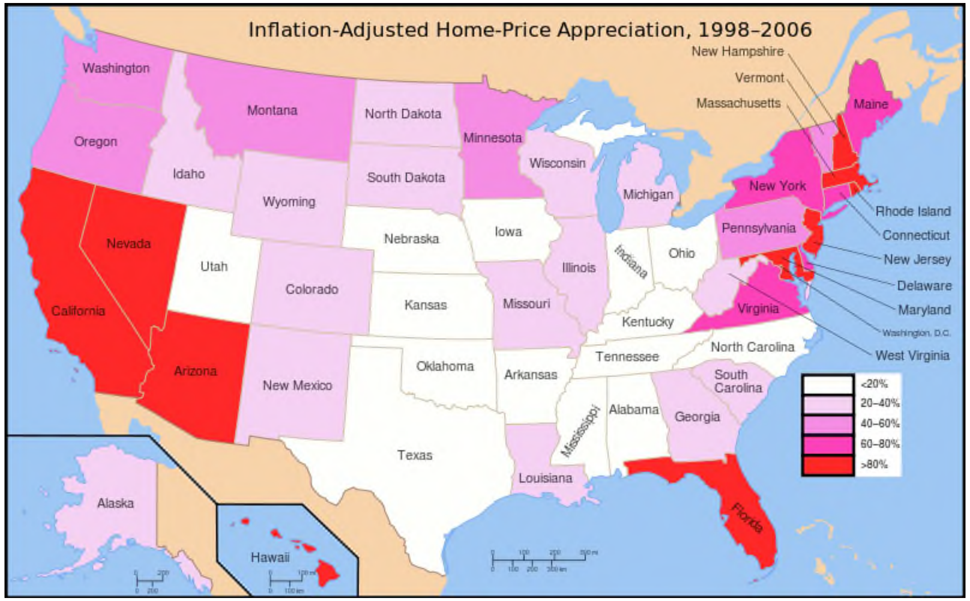
   B. Non-Tax Revenue

   C. Key Credit / Structural Considerations

IV. Use of Tax Increment Financing

National Home Values

- From 2000 to 2006 the national median home value went from approximately $160,000 to over $250,000 (an increase of 56% nationally).
- Housing prices reached an all-time high in July of 2006. Since then prices have declined nationally 34% and reached their lowest level in March of 2012.
- Ohio experienced less than 20% home price appreciation from 1998 to 2006.



"I THOUGHT WE WERE JUST BUYING A HOUSE!"

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Source:
S&P / Case-Shiller U.S. National Home Price Index
Bloomberg

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Legal / Financial Considerations surrounding Demolition Funding – State

- Article VIII Section 6 of the Ohio Constitution prohibits the lending of aid and credit:

"No laws shall be passed authorizing any county, city, town or township, by vote of its citizens, or otherwise, to become a stockholder in any joint stock company, corporation, or association whatever; or to raise money for, or to loan its credit to, or in aid of, any such company, corporation, or association."

This prohibition has been interpreted as preventing the issuance of obligations secured by taxes (as opposed to non-tax revenues) for the benefit of private parties.

Legal / Financial Considerations surrounding Demolition Funding – State

- Article VIII Section 16 of the Ohio Constitution:

"To enhance the availability of adequate housing in the state and to improve the economic and general well-being of the people of the state, it is determined to be in the public interest and a proper public purpose for the state or its political subdivisions . . . to provide, or assist in providing, by grants, loans, subsidies to loans, loans to lenders, purchase of loans, guarantees of loans, or otherwise as determined by the general assembly, housing, including shelters to provide temporary housing, in the state for individuals and families by the acquisition, financing, construction, leasing, rehabilitation, remodeling, improvement, or equipping of publicly or privately owned housing, including the acquisition of real property and interests in real property. Laws, including charters, ordinances, and resolutions, may be passed to carry into effect those purposes . . . . . And any other actions authorized by the general assembly shall not be subject to the requirement, limitations, or prohibitions of any other section of Article VIII, or Sections 6 and 11 of Article XII, Ohio Constitution."

Legal / Financial Considerations surrounding Demolition Funding - State Law Issues

State Law Issues: Lending of aid and credit – can sales tax bonds be issued? For residential, the answer is yes. For other purposes, would need to get past the issue of "permanent improvement"

- Bonds issued would be pursuant to the authority granted to counties under Section 133.081 of the Ohio Revised Code, which grants counties the power to issue bonds payable solely from sales taxes, to pay costs of "permanent improvements" as defined in Section 133.01 (CC) of the Revised Code.

- The structure is novel, in that it would fund grants to municipalities to fund demolition of property used for commercial or residential purposes that are not county-owned.

- In Ohio, charter counties (Summit and Cuyahoga County) have broad powers which would be otherwise limited by the provisions of the Revised Code. See OAG 85-047.

- As such, charter counties could conclude that the use of bond proceeds to fund something other than a "permanent improvement" as defined in Section 133.01(CC) of the Ohio Revised Code is permissible (as such use is not prohibited by the Ohio Constitution).

- Funding of residential demolition is within the power of counties under Article VIII, Section 16 of the Ohio Constitution. However, it is not clear that debt may be issued to fund such demolition by all counties.

Legal / Financial Considerations surrounding Demolition Funding - State Law Issues

State Law Issues: Lending of aid and credit – can sales tax bonds be issued? For residential, the answer is yes. For other purposes, would need to get past the issue of "permanent improvement"

- A county's power to undertake an action is separate from its power to issue debt to fund such action.
- The use by a charter county of sales tax-backed bonds to fund demolition on privately-owned commercial properties would seem to be authorized, although Section 133.081 of the Revised Code authorizes the issuance of bonds only to fund "permanent improvements." Authority for such an issuance would be the home rule powers of the charter County.
- Such an issuance needs to be considered within the context of the restrictions imposed by Section 6 of Article VIII of the Constitution, which prohibits the raising of money or loaning the credit of a county to private corporations.
- In order to accomplish this that grants be made only to accomplish demolition on privately owned properties that are suitable for residential use or, if not suitable for residential use, only if those properties are publicly owned. The issue could be researched in more depth, but as an initial matter, using the proceeds of tax-backed bonds to fund demolition of privately owned property which is used or to be used for commercial purposes is a potential violation of the Ohio Constitution.

Legal / Financial Considerations surrounding Demolition Funding - Federal Tax Issues

Federal Tax Issues: Issue of tax-backed bonds being utilized to make grants to municipalities to make loans for commercial properties. Tax Exemption – if these are grants, not loans, then there is a possibility of achieving a tax exemption

- Bonds issued could potentially be issued as tax-exempt bonds, despite the fact that the demolition may occur on privately owned property. In order to assure the tax exemption under such circumstances, the bonds as issued could be secured only by generally applicable taxes, such as sales taxes or possibly non-tax revenues.
- In the event that a county would seek to pledge additional revenues to repay the bonds, careful attention would need to be given to the nature of those revenues to insure that the private loan test is not met (thus preserving the bond's tax-exempt status).
- Additional attention would need to be given to the use of the proceeds by third parties. In order to issue the bonds, counties must have a reasonable expectation that the proceeds will be spent in accordance with the requirements of the Internal Revenue Code. There are two levels to this inquiry – the first being the expectation that the proceeds will be deemed spent in a timely manner and the second structuring a program that ensures that these expectations can be met.
- In the first instance, counties should document that there is a demand and need for these bond proceeds. With respect to the second question, counties should establish a program that would preserve accountability while at the same time avoiding a situation where the proceeds are deemed to be loaned by a particular county, either as a result of actions taken by the county or by its grantees.
- It would be best, from a federal tax perspective, to structure the program so that participating municipalities are required to either use the proceeds directly or grant the proceeds to individuals that have already met the requirements for the program.
- This is an issue that, given the natural concern of counties with ensuring that limited resources are used wisely and ethically, needs to be carefully considered when structuring the demolition program.

Credit / Alternative Structures: *(Sales Tax Revenue / Nontax Revenue)*

Establishing a New Credit (Sales Tax Revenue Bonds)

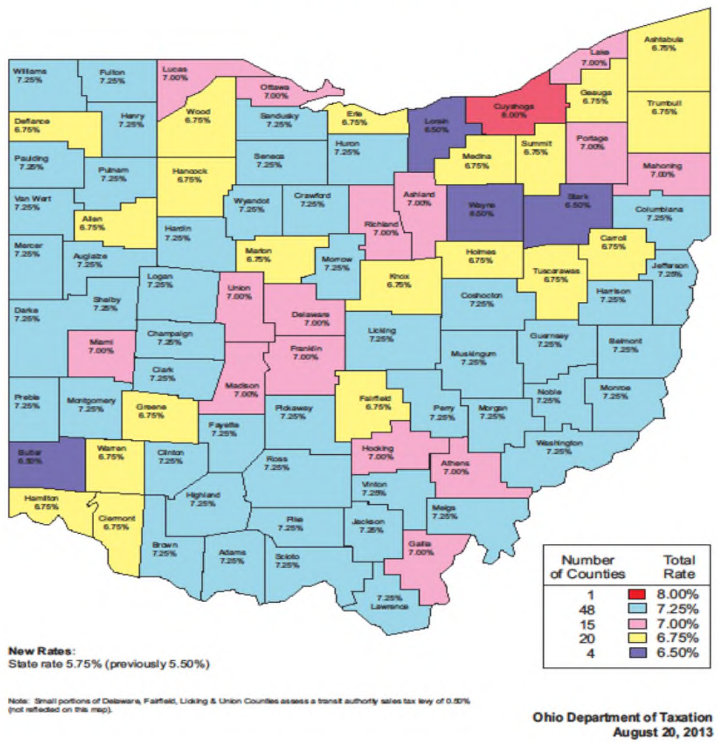
Authorization:

- An amendment to the Ohio revised code in 1996 provided for the ability for county's to issue sales tax-supported obligations. (ORC133.081)
- The taxing authority of a county may not repeal, rescind, or reduce any portion of sales tax pledged to the payment of debt charges for the life of the bonds, and no portion of the pledged sales taxes can be repealed or reduced by the electorate of a county. (133.08(H))

Rating and Structural Considerations:

- **Pledge:** Includes overall economic strength and the nature of the sales tax pledge as well as revenue trend /volatility.
  - Pledged sales tax is of the authorized purpose and acceptable duration.
  - **Legal Structure:**
  - Trust Structure vs. Bond Ordinance
  - Flow of Funds / Payment Timing
  - Bona Fide Bond Service Fund – Debt service transferred from the county to the pledged Bond Service Fund monthly in 1/6 (interest) and 1/12 (principal) amounts.
  - Typically 30 days prior to payment date, if sales tax is not directly assigned to the Trustee.
  - **Covenants:**
  - Non-Impairment - Sales Tax Pledge
  - Appropriation of Debt Service
  - No change in authorizing legislation
  - **ABT:** Range from 1x to 2x – rating and structure specific.
  - **DSRF:** Depending on the county's credit profile, available coverage and consideration of appropriate legal covenants.
  - **Pricing Factors**

Total State and Local Sales Tax Rates, By County
Effective September 2013



Source: KBCM;
Moody's Investor Services : Rating Methodology: US Public Finance Special Tax Methodology May 2012

Establishing a New Credit (Nontax Revenue Debt)

- Bringing a new credit to market requires strategic policy discussions in order to formulate appropriate covenants and an overall structure that provides flexibility to the Governmental Issuer while also achieving the desired ratings outcome.

Security and Sources of Payment (City and County):

The nature and amount of the Nontax Revenue pledge must be analyzed to determine the amount and adequacy of the subject pledge.

- **Charges For Services**
- **Payments in Lieu of Taxes**
- **Fines and Forfeitures**
- **License and Permit Fees**
- **Intergovernmental Reimbursements / Revenue**
- **Investment Earnings Credited to the General Fund**
- **Asset Sale Proceeds**
- **Rental Income**

Rating Considerations (Source: Moody's Investors Service - US Public Finance Special Tax Methodology / May 2012):

- **Taxable Base and Pledge:** Includes overall economic strength;
- **Legal Structure:** Includes considerations around a Trustee, an Additional Bonds Test ("ABT"), and a Debt Service Reserve Requirement ("DSRF");
- **Financial Metrics:** Includes MADS coverage ratio, as well as revenue trend / volatility.

Structural Considerations:

- **Trustee / Trust Indenture:** A trust indenture is common as the rating agencies would prefer such a consideration as it more readily provides for a "segregation of funds";
- **ABT:** The establishment of an ABT is extremely important in an indenture;
- **DSRF:** Depending on the Governmental Entities credit profile, significant coverage of the Nontax Revenue pledge, and consideration of appropriate legal covenants, a DSRF will likely not be necessary.
- **Pricing Factors**

Key Credit / Structural Considerations

Taxable Base and Pledge (Economic Strength)

Economic strength is based on the taxable base's diversity, size, breadth, stability, and growth potential, as well as an assessment of the area's socioeconomic indicators.

Socioeconomic indicators are key for primarily residential areas. A variety of socioeconomic measures offer an indication of the ability to generate future pledged special tax revenues including population and unemployment trends, per capita income (PCI), and median family income (MFI).

	Economic Strength
Aaa	Very strong and very well diversified economic base with solid growth or PCI/MFI is 200% or greater of national median for primarily residential bases
Aa	Strong and well diversified economic base with solid growth or PCI/MFI is 125% - 200% of national median for primarily residential bases
A	Developed and reasonably diversified economic base with average growth or PCI/MFI is 75% - 125% of national median for primarily residential bases
Baa	Small to evolving economy with modest diversification and some concentration with slow to declining growth or PCI/MFI is 50% to 75% of national median for primarily residential bases
SG (Speculative Grade)	Deteriorating economic base with very little diversification or significant concentration with declining growth or PCI/MFI is 50% or below of national median for primarily residential bases

Source:
Moody's Investor Services : Rating Methodology: US Public Finance Special Tax Methodology May 2012

Taxable Base and Pledge (Nature of the Special Tax Pledge)

Strength of the tax being pledged based on essentiality (i.e. what is actually being taxed), as well as historic tax revenue volatility through different economic cycles and expectations for future performance.

The stronger special tax pledges (sales, utility, and income taxes) are levied on more essential items or consumer-based services, are typically applied broadly, and are more resilient during economic downturns.

	Nature of the Special Tax Pledge
Aaa	Very Broad (e.g. Sales, Utility, Income)
Aa	Broad (e.g. Sales, Utility, Income)
A	Average (e.g. Sales, Utility, Income)
Baa	Narrow (e.g. Hotel)
SG (Speculative Grade)	Very Narrow (e.g. Document Stamp and Hotel)

Source:
Moody's Investor Services : Rating Methodology: US Public Finance Special Tax Methodology May 2012

Legal Structure (Additional Bond Test)

The legal structure is a vital component of the Special Tax Bond rating analysis as it provides bondholder safeguards that provide a buffer against non-payment during periods of economic disruption or short-term interruption of revenues.

Sector norm is for Additional Bonds Test to be applied historically verses prospectively (i.e. preceding three year average of annual special tax revenues result in a amount not less than “X” of the largest amount required to pay bond service charges in any succeeding year). Majority of ABTs for local government issues are in the 1.15x – 1.50x.

	Additional Bond Test
Aaa	3.0x and higher
Aa	1.76x to 2.99x
A	1.26x to 1.75x
Baa	1.0x to 1.25x
SG (Speculative Grade)	No limit

Source:
Moody’s Investor Services : Rating Methodology: US Public Finance Special Tax Methodology May 2012

Legal Structure (Debt Service Reserve Fund (DSRF) Requirement)

DSRF requirements can have a meaningful impact on the credit quality of Special Tax Bonds. Most special taxes coupled with the vulnerabilities associated with economic cycles and potential delays or disruption in the collection cycle.

The industry norm for a DSRF is the lesser of the standard 3-prong test (i.e. 10% of initial principal, maximum annual debt service, or 125% of average annual debt service). A DSRF is of less importance for issuers with strong economic strength and debt service coverage and have minimal likelihood of revenue disruption.

	Debt Service Reserve Fund
Aaa	DSRF funded at level greater than 1-year of Maximum Annual Debt Service (MADS)
Aa	DSRF funded at 1-year of Maximum Annual Debt Service (MADS)
A	DSRF funded at lesser of standard 3-prong test
Baa	DSRF funded at level less than 3-prong test or a springing DSRF
SG (Speculative Grade)	No DSRF (or DSRF funded with low rated or speculative grade surety provider)

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Source:
Moody's Investor Services : Rating Methodology: US Public Finance Special Tax Methodology May 2012

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Financial Metrics (Maximum Annual Debt Service Coverage Ratio)

MADS coverage indicates to what extent future peak debt service can be covered from the current year's pledged revenues. This is a particularly important ratio for newly levied special tax pledges that have a limited collection history and may have an ascending debt service schedule over a long period of time that requires future revenue growth for full debt repayment.

MADS coverage calculated by dividing the annually collected and legally available pledged special tax revenues by the largest single year future debt service payment on all outstanding parity debt.

Rating	Maximum Annual Debt Service Coverage Ratio
Aaa	Over 4.5x
Aa	2.51x to 4.5x
A	1.51x to 2.5x
Baa	1.1x to 1.5x
SG (Speculative Grade)	Less than 1.1x

Source:
Moody's Investor Services : Rating Methodology: US Public Finance Special Tax Methodology May 2012

Financial Metrics (Revenue Trend)

Revenue trend is based on the magnitude of the annual declines, as well as the number of consecutive years in which the declines occur.

	Revenue Trend
Aaa	Significantly improving with one to no historic decline
Aa	Generally improving with few historic declines
A	Stable with some historic declines
Baa	Declining
SG (Speculative Grade)	Rapidly Declining

Source:
Moody's Investor Services : Rating Methodology: US Public Finance Special Tax Methodology May 2012

Financial Metrics (Revenue Volatility)

Revenue volatility is evaluated based on the magnitude of historical revenue declines. Large one-year declines or large sequential year peak-to-trough declines result in a lower score on volatility than multiple consecutive modest declines because they indicate greater volatility and the higher possibility of a revenue "shock" within a short time period.

	Revenue Volatility
Aaa	Has never declined
Aa	Negative fluctuations generally within 0% to 5%
A	Negative fluctuations generally within 5% to 10%
Baa	Negative fluctuations generally within 10% to 15%
SG (Speculative Grade)	Negative fluctuations greater than 15%

Source:
Moody's Investor Services : Rating Methodology: US Public Finance Special Tax Methodology May 2012

Use of Tax Increment Financing ("TIF")

Tax Increment Financing - Overview

- Tax increment financing ("TIF") involves public body (municipal corporation, county or township) implementation of a state statutory program under which a real property tax exemption is granted with respect to the increment of increase in assessed valuation of certain designated parcels resulting from real property improvements made to such parcels.

- The property owners of the designated parcels make payments in lieu of taxes ("PILOT"), equal to the amount of taxes that would otherwise have been paid with respect to the exempted real property improvements (may include public infrastructure improvements, e.g. parking garages). As a result, implementation of tax increment financing creates a "cash flow", back to the public body with respect to the exempted real property improvements, in the amount of the taxes that otherwise would have to be paid on such real property improvements. This cash flow may be used to secure financing for public improvements or in some cases private improvements.

- Tax Increment Financing works by locking in the taxable (assessed) value of real property at the value it holds at the time a municipality authorizes TIF legislation.

- Entities seeking to utilize Tax Increment Financing normally enact legislation that designates the properties to be included in the TIF District and declare that all or a portion of the value of future real property improvements (the incremental value) within the TIF District shall be exempt from real estate taxes for a specified time period.

- However, although real estate taxes are exempted, a taxpayer whose property is located within a TIF District continues to make payments to the taxing jurisdiction in an amount equal to the real property tax liability that otherwise would have been due had the property not been exempted. These "payments in lieu of taxes" (PILOTs), or Service Payments, may be collected and deposited into a separate account to fund the debt service on outstanding TIF bonds.

Tax Increment Financing – The Ohio Experience

- Payments in lieu of taxes are generally to be applied to infrastructure improvements.

- The definition of public infrastructure improvement covers TIFs by municipalities, counties and Townships.
  - 5709.40 (A)(7) - "Public infrastructure improvement" includes, but is not limited to, public roads and highways; water and sewer lines; environmental remediation; land acquisition, including acquisition in aid of industry, commerce, distribution, or research; demolition, including demolition on private property when determined to be necessary for economic development purposes; stormwater and flood remediation projects, including such projects on private property when determined to be necessary for public health, safety, and welfare; the provision of gas, electric, and communications service facilities, including the provision of gas or electric service facilities owned by nongovernmental entities when such improvements are determined to be necessary for economic development purposes; and the enhancement of public waterways through improvements that allow for greater public access.

  - 5709.40 (B) – requires identification of public infrastructure improvements to be funded with PILOT payments.

- Public infrastructure improvements to be funded must benefit the area that generates payments in lieu of taxes.

- Chapter 725 (applicable only to municipalities) takes a similar approach.
  - Urban renewal project" . . . Includes . . . undertakings and activities of a municipal corporation in an urban renewal area for the elimination and for the prevention of the development or spread of slums and blight, and may involve slum clearance and redevelopment in an urban renewal area, or rehabilitation or conservation in an urban renewal area, or any combination or part thereof, in accordance with an urban renewal plan, and such aforesaid undertakings and activities may include acquisition of a slum area or a blighted area, or portion thereof, demolition and removal of buildings and improvements; installation, construction, or reconstruction of streets, utilities, parks, playgrounds, public buildings and facilities, and other improvements necessary for carrying out in the urban renewal area the urban renewal objectives in accordance with the urban renewal plan, disposition of any property acquired in the urban renewal area, including sale, leasing, or retention by the municipal corporation itself, at its fair value for uses in accordance with the urban renewal plan; carrying out plans for a program of voluntary or compulsory repair and rehabilitation of buildings or other improvements in accordance with the urban renewal plan; the acquisition, construction, enlargement, improvement, or equipment of property, structures, equipment, or facilities for industry, commerce, distribution, or research from the proceeds of urban renewal bonds issued pursuant to division (C) of section 725.05 of the Revised Code; and acquisition of any other real property in the urban renewal area where necessary to eliminate unhealthful, unsanitary, or unsafe conditions, lessen density, eliminate obsolete, or other uses detrimental to the public welfare, or otherwise to remove or prevent the spread of blight or deterioration, or to provide land for needed public facilities.

Tax Increment Financing – Credit Considerations

- Tax increment only is received if there is an increase in value. In today's market, it is difficult if not impossible to issue Bonds secured only by TIF Revenues without additional security (like a general obligation pledge or a letter of credit).

- Public bodies may wish to consider requiring minimum service payments, or providing developer or company with TIF Revenues directly, and letting developer or company secure private financing.

- Cash flow is delayed because of tax collection system in Ohio where taxes are collected the year after valuation is established. Significant payments of capitalized interest are often required.

Tax Increment Financing – Converting TIF into Funding

- Cash advance. Public body can make a cash advance out of its available funds, with the intent of reimbursing itself out of future payments in lieu of taxes.

- State loan. Public body might seek to obtain a state loan, and use TIF PILOTS to repay such state loan.

- Obligations. Public body might issue obligations (such as industrial development bonds, general obligation bonds, or other obligations appropriate based on the facts of the project and under applicable state law) and pay debt service in whole or in part out of payments in lieu of taxes.

- Supplemental Revenues. Employ revenues from other sources that are the responsibility of other parties (letters, of credit, special assessments, community development charges). Unfortunately, these structures have proven to be problematic in the marketplace, at least to the extent that they involve market or construction risk.

Tax Increment Financing – Usefulness for Ohio Land Banks

- As Ohio TIF relies on an increase in property value and mandates that public infrastructure improvements that benefit the TIF area be undertaken, its bias is towards the economic development project.

- County has no power to TIF properties located within municipalities – so direct access to TIF revenues is difficult; must be done through municipalities or through cooperative agreements.

- While Ohio allows some TIF of residential properties, authority is limited, and many restrictions are placed upon that power.

- During the time that properties are held by land banks they are exempt from taxes – this creates an opportunity for creativity (new community authorities (Chapter 349).

Tax Increment Financing as a Tool for Land Banks – Genesee County, Michigan Model

- Main community in Genesee County is Flint. During the height of the recession over 12% of properties within Genesee County were vacant.

- County's focus was the clean up of vacant residential property.

- Program incorporated
  - Expedited foreclosure process
  - Disposition of properties according to a plan instead of a mechanical bidding process.
  - Elimination of Tax Liens
  - Use of Tax Increment Financing for Cross Collateralization.

Tax Increment Financing as a Tool for Land Banks – Genesee County, Michigan Model

TIF Cross Collateralization – Key Elements

- Michigan Land Bank Legislation
  - Defined any property in a land bank as a "brownfield"
  - Allowed scattered site non-contiguous TIFs for land banks
  - Allowed land-bank owned properties to use 0 as the basis for measuring tax increment.

- Impact:
  - All land bank properties eligible for TIF
  - Allowed a matching for land banks to take advantage of TIF.

- TIF debt issued based on projected revenues from putting properties back on the tax rolls; as many as 4,000 non-contiguous properties batched into TIF plans. So stronger properties generated tax revenue to subsidize sites needing more upfront investment (often demolition) to create economically viable sites.

Ohio Takeaways

- In order to implement a residential vacant property model using a Genesee County model
- Clear authority needs to be established for creating non-contiguous TIFs over a large area for abandoned properties.
- Incremental value for properties conveyed by a land bank must be set at zero.
- Issues with overlapping subdivisions would need to be addressed.
  - School districts would likely object, but perhaps 5 year duration would be helpful.
- In case of residential vacancy, subdivisions could potentially issue tax backed bonds (or provide guaranties) to support TIFs if legislation were passed by the General Assembly permitting such a structure.