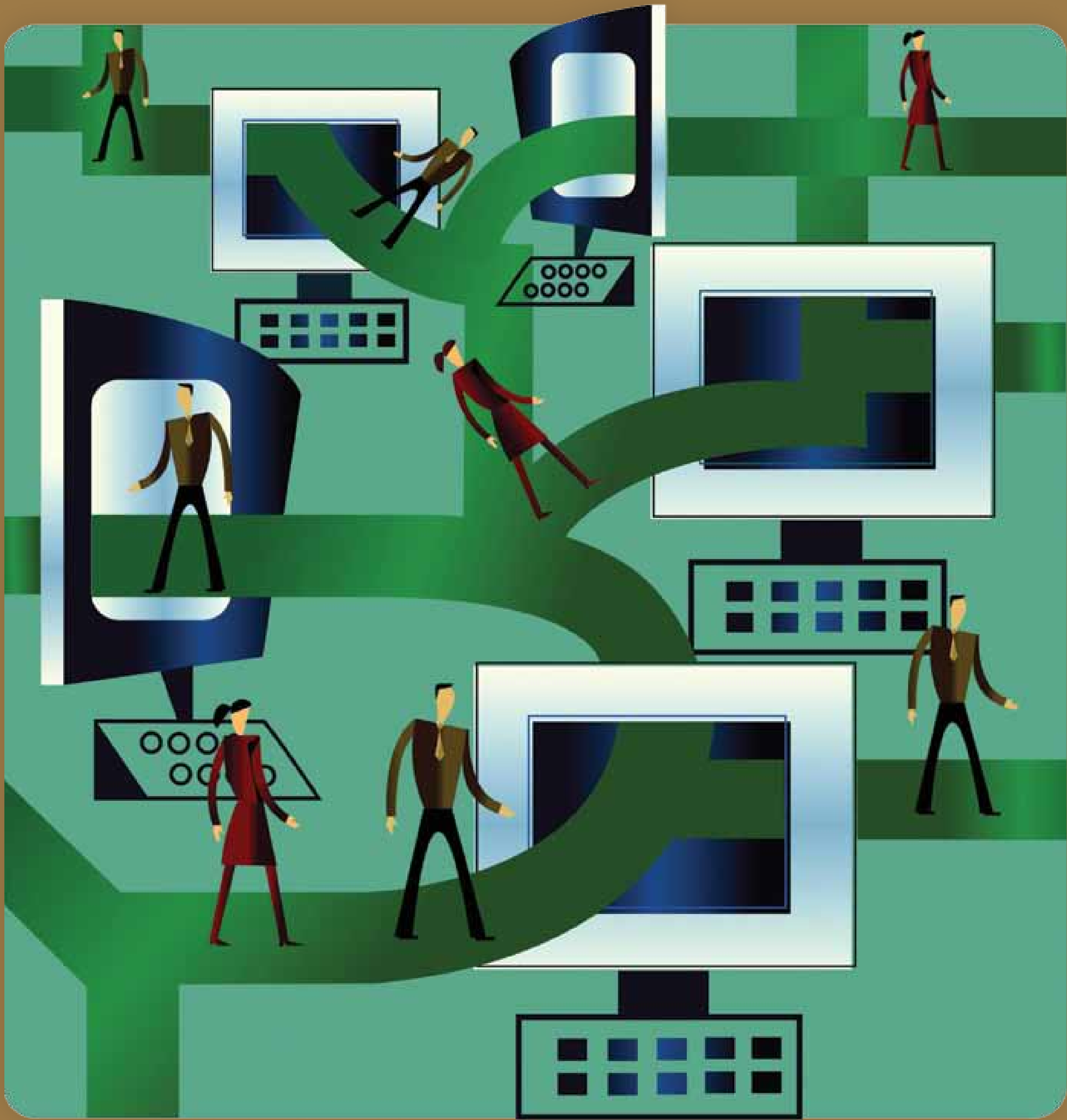

MINI-BONDS

PUBLIC ENGAGEMENT AND PUBLIC INVESTMENT

BY ELIZABETH FU

A recent GFOA membership survey identified infrastructure spending as the third biggest challenge facing local governments. The research supports this; the oft-cited 2013 American Society of Civil Engineers' Report Card for America's Infrastructure, which analyzed a number of factors to provide a comprehensive assessment of infrastructure conditions and needs in the United States, gave the country a D+ overall.[1]

Funding strategies for infrastructure improvements and asset maintenance generally include pay-as-you-go, debt issuance, and public-private partnerships, with varying degrees of public involvement in the budgeting and planning phases. The need for transparency has led some jurisdictions to connect directly with the public when funding infrastructure projects, and recent projects — debt issuance by two cities and a new platform to purchase municipal debt — suggest that the strategy can be successful.

DENVER'S STORY: A PREVIOUS ISSUER IMPROVES ITS PROCESS

Mini-bonds are not new in public finance. For example, the City and County of Denver, Colorado, issued its first mini-bonds in 1990, and other governments, like the City of New York,[2] have issued mini-bonds — generally issued to raise funds for public capital projects, but the key distinction is that they are available in smaller dominations to make them available and affordable to retail investors.[3] Mini-bonds are unrated, and many governments pledge their full faith and credit to make the instruments more secure and attractive to retail investors.

> In 2014, Denver sold out a $12 million bond issue in less than 20 minutes.

Why are mini-bonds of interest again? Imagine selling out a $12 million bond issue in less than 20 minutes, which is exactly what happened with Denver in 2014.[4] A number of circumstances factored into Denver's success, including four successful mini-bond issuances in prior years; a low interest-rate climate, which attracted investors looking for higher-yielding products; and the use of technology to make it easier to purchase the bonds.

A former revenue director is thought to have first suggested the idea of mini-bonds, with the support of the then-mayor. With internal stakeholders on board, Denver presented the idea to its bond counsel and financial advisor. Seeing it as a novel product, they were keen to test mini-bonds and use the city's experience to help other governments that might be interested. The 1990 issuance generated nearly $6 million to finance the expansion of a public library, upgrades to city golf courses, and streetscape projects.[5]

Denver also raised approximately $4 million in 1992 for citywide library improvements, $3 million in 1999 for neighborhood programs — such as upgrades to parks and senior centers as well as building a new police station — and $9 million in 2007 for the downtown Denver Justice Center.

In 2013, members of city council and the city's department of finance begin to discuss the possibility of issuing more mini-bonds. Denver's director of capital funding had started with the city in 2014 and was not involved in the prior mini-bonds; she and her colleagues saw it as a learning opportunity. The finance team began to run scenarios for a possible issuance, identifying a project that had a tangible connection to the community. Ultimately, Denver decided it would issue $12 million for capital maintenance expenditures that represented the last tranche of the Better Denver Bond Program, which was authorized by voters in 2007.[6] Projects under this program focus on infrastructure investments that have a direct community impact, including libraries, parks, and facilities related to health and human services, public safety, and culture.[7]

From an issuer's perspective, where the mini-bond issuance process really distinguishes itself from traditional issuance of a general obligation bond is the internal administrative work required. To make a simple comparison, Denver's process for issuing a traditional general obligation bond entails council approval and document review with the jurisdiction's legal department, financial advisor, external bond counsel, and other working group members, as well as outreach and engagement with rating agencies. Denver's triple-A general obligation bond rating[8] meant more demand for its paper and lower borrowing costs, all of which ultimately benefits Denver residents.

By contrast, Denver's mini-bond program required the city to set up the debt structure as well as the logistics and management for the sale of the bonds, including marketing and operating efforts. Investors were allowed to purchase the mini-bonds via different means: online, mail, and hand delivery. This meant developing a prioritization system for processing orders. Even developing the order form was a discrete task requiring involvement from the finance and legal departments to ensure conciseness and accuracy. The city was also responsible for developing the bond itself. Unlike traditional issuances, where the bonds are book-entry securities, Denver created a physical bond that would be mailed to investors.

Denver's mini-bonds succeeded largely because of three factors: four successful mini-bond issuances in prior years; a low interest-rate climate, which attracted investors looking for higher-yielding products; and the use of technology to make it easier to purchase the bonds.

Marketing was another critical component. The typical targeted audience for traditional bonds is institutional investors, but mini-bonds are targeted to local residents — residents of Colorado, in this case. The city engaged an external marketing consultant to let the public know about the mini-bond offering, helping develop brochures and postcards that were mailed to previous mini-bond buyers. Denver's mayor issued a press release and video,[9] and his office made announcements on Facebook and Twitter. The city also ran print ads in The Denver Post and digital ads on its website to promote the mini-bond sale.

One focus of the program was to achieve citizen participation, so quality customer service was a top priority throughout the process. The finance department set up a dedicated phone line for the mini-bonds inquiries and worked to develop and provide scripts to employees to help address questions from prospective purchasers.

The key piece to making the ordering process easy for customers was to have an online platform for placing the orders. Initially, Denver had wanted to develop the platform in-house through its technology services department, but the payment security requirements, required testing, and customizations proved too time consuming and resource-intensive. The city turned to a third party to help develop an online ordering platform. Getting it to function as Denver had envisioned was a long process, and this is the reason for the 9- and 14-year maturity of the bond. The city originally intended to issue bonds that would mature after 10 and 15 years.

Given how quickly the mini-bonds sold out, it appears that the online ordering platform did make it easier for many retail investors to place their orders. The actual processing of the orders were handled manually by the third party, though. The two different maturities also made it difficult for Denver to know when one maturity was sold out, since the orders were flooding in so quickly. After the reconciliation, Denver had to refund a few hundred orders.

The mini-bonds definitely met Denver's goal of helping residents invest in the community, so the project was well worth the additional resources and effort. Of course, this tool isn't for everyone, particularly triple A-rated entities that might have trouble with the additional workload, the level of resources needed for administration, or the additional cost.

VANCOUVER'S STORY: THE FIRST-TIME ISSUER

The chief financial officer (CFO) and the treasurer of Vancouver, Washington, had discussed the possibility of issuing mini-bonds for some time. Waiting for the appropriate application, they saw an opportunity in a renovation project of the city's historic reserve area. The U.S. Army once had a military base in Vancouver, and it had recently turned the barracks, including officers' homes, over to the city to refurbish and renovate for other uses. Because of the community and historic significance the property held for the jurisdiction, this project seemed ideal.

The city manager and city council both supported the idea to issue small-domination bonds targeted to the local community. Next, the logistics and the programmatic questions needed to be addressed.

Seeking input from the city's bond counsel and underwriter, the CFO and treasurer learned that the city's bond counsel had helped other governments with mini-bonds issuance in the 1980s and was receptive to the project — although they did ask if the city was ready for all the work involved.

One of the initial programmatic questions was the definition of the investor. Denver's mini-bonds were open to all Colorado residents, as the city saw that many state residents are linked to Denver in some form or fashion — traveling on Denver's roads, using its cultural and entertainment facilities, or traveling to and from its airport. Vancouver felt that the individuals in Clark County would connect with the historic preservation of the barracks. If the issuance were expanded to the state, investor attention would likely have less to do with the historic community perspective and more about the financial/investment connection, which wasn't the city's objective in issuing mini-bonds.

Vancouver communicated with Denver to better understand the processes and program Denver had developed. Vancouver also borrowed Denver's mini-bond order form for the Vancouver's heritage bond order form, although it made slight modifications based on information the State of Washington's fiscal agent required as the bond registrar.

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Like Denver, the intention was to have an automated ordering process and, like Denver, Vancouver ran into hurdles. Vancouver was on a tight timeframe for financing the project and having proceeds available, as well as issuing refunding bonds to advance refund three other limited tax general obligation bond issues; as a result, it had to switch to a manual ordering process, as developing a secure online ordering system would take too long. From there, Vancouver set up procedures around processing orders, which would come in through mail or hand delivery. Staff would check the secure drop box and record the order in which the envelopes arrived.

In working with the underwriter, Vancouver determined that $1.5 million in heritage bonds would be available. Seven maturities were offered, based on a debt service arrangement that would tie with the traditional bonds the city was also issuing for the barracks renovation project. The combined issues were structured as level debt service payments to match the projected revenues associated with the project. The amount available for each maturity was therefore relatively small, ranging from $155,000 to $220,000, so the city was careful in setting the minimal domination at an amount ($500) that remained efficient to process, and the maximum total investment ($10,000 per household) at a level that wouldn't allow a single family to buy an entire maturity period. To simplify logistics, the city also followed Denver's model in paying interest at maturity instead of the traditional general obligation bond issue structure of small interest payments twice per year.

Mini-Bonds versus Brokerage Model

Mini-bonds are issued by a public entity, and investors receive a tangible bond certificate that they present at the time of maturity for redemption — like U.S. Savings Bonds. There is no physical certificate under a brokerage model; the bond is held in the name of the brokerage firm, and the individual investor's name is recorded in its books (i.e., book-entry form). Book-entry securities can be traded on a secondary market.

Summary of Mini-Bond Issues by Denver and Vancouver

	2014 Denver Mini-Bonds	2015 Vancouver Heritage Bonds
Issuer	City/County of Denver, CO Population: 682,545	City of Vancouver, WA Population: 172,860
City's General Obligation Bonds Credit Rating	Aaa by Moody's and AAA by Fitch and Standard & Poor's	Aa3 by Moody's and AA by Standard & Poor's
Purpose	Complete the final phases of Better Denver projects, including improvements to the city's outstanding cultural facilities	Renovation of four historic buildings of the former Army West Barracks near Officers Row
Amount Sold/Amount Available	$12 million/$12 million	$1.3 million/$1.5 million

Structure

2014 Denver Mini-Bonds

Maturity	Total Amount of Bonds Available
2023	$6 million
2028	$6 million

2015 Vancouver Heritage Bonds

Maturity	Total Amount of Bonds Available
12/1/2021	$200,000
12/1/2022	$220,000
12/1/2023	$205,000
12/1/2024	$195,000
12/1/2025	$185,000
12/1/2026	$175,000
12/1/2027	$165,000
12/1/2028	$155,000

Interest Rate and Earnings

2014 Denver Mini-Bonds

		At $500 per each bond	
Maturity	Interest Rate *Tax-Free Yield	Interest Earnings Paid at Maturity	Total Value of Investment at Maturity
2023	4.38%	$250	$750
2028	4.89%	$500	$1,000

2015 Vancouver Heritage Bonds

		At $500 per each bond	
Maturity	Interest Rate *Tax-Free Yield	Interest Earnings Paid at Maturity	Total Value of Investment at Maturity
12/1/2021	3.64%	$131.24	$631.24
12/1/2022	3.85%	$164.57	$664.57
12/1/2023	4.03%	$200.79	$700.79
12/1/2024	4.18%	$239.52	$739.52
12/1/2025	4.37%	$285.92	$785.92
12/1/2026	4.50%	$332.68	$832.68
12/1/2027	4.60%	$381.24	$881.24
12/1/2028	4.70%	$434.46	$934.46

	2014 Denver Mini-Bonds	2015 Vancouver Heritage Bonds
Eligible Purchasers	Colorado residents	Residents of Clark County, WA
Purchase Limits	40 per registered bond owner ($20,000)	$10,000 per household
Availability Period	August 4-8, 2014	May 26 - June 5, 2015
Purchase Method	Online, mail, or hand delivery	Mail or hand delivery

To get the word out about the heritage bonds, the city's internal communications department marketed the issue via social media and the city's website; it also sent targeted e-mails to community groups. The local newspaper published articles about the project. Before it started the marketing effort, though, the city was careful to seek the perspective of non-financial city employees on the materials to make sure they were clear to residents who didn't have financial backgrounds. The city's tight timeframe affected its marketing campaign, as well. Several residents asked if they could purchase heritage bonds after the order period, and some wondered why they couldn't submit orders and purchase the bonds online.

> Mini-bonds aren't for everyone, particularly triple A-rated entities that might have trouble with the additional workload, the level of resources needed for administration, or the additional cost.

Selling 86 percent of available bonds is nothing to scoff at, especially for the city's first time in issuing a new tool. The issuance met the city's objective in allowing the community to be engaged through a solid financial investment and also feel that it had a part to play in community investment. Was the issuance completed in the most efficient manner? No, because orders and payments had to be processed manually. But the city is still pleased with the project. The city does caution that mini-bonds are not for every entity, warning entities not to force a proposed issuance to fit a mini-bond model unless certain elements are in place (e.g., community connection, community engagement in a project or process that has a high degree of public sentiment, and financial security).

NEXT STEPS AND NEW PLATFORM

Both Denver and Vancouver have been asked when they are going to issue their next mini-bonds. For Denver, it is working to develop its next GO bond issuance which requires voter approval, and depending on that timing, it may look into another mini-bond issuance. In Vancouver's case, the city's financial policy prioritizes pay-as-you-go. The city is now considering issuing debt, but finding an appropriate project to match the purpose of mini-bonds, especially one that would elicit the same level of community appeal, is difficult.

The success that Denver and Vancouver had with their mini-bonds is generating discussion about individual retail investors and municipal bonds. One startup, Neighborly (neighborly.com), offers a brokerage model that allows individuals to invest in public projects they're interested in, with a lower minimum investment.

Like Denver and Vancouver, Neighborly is also tapping into the connection between individuals and their communities. In surveying its users, Neighborly found a strong interest in investing in schools (e.g., the connections that individuals may have to these institutions from high school football games to homecoming at the alma mater). Neighborly looked for offerings to meet the interest of its investors, including one by San Leandro Unified School District to support facility upgrades and expansion of classrooms and libraries. To make this offering available in $500 denominations, Neighborly purchased the bonds and formed a limited liability corporation (LLC) to own them. Neighborly then sold shares of the LLC to investors.[10]

This example is more roundabout than how the company's actual brokerage model operates, which is to work directly with the issuers. Yet, it was an important example for Neighborly to demonstrate what mini-bond investing could look like. The company's full vision is to help governments issue bonds — giving issuers a platform to enter their desired financing parameters, rating agencies a way to evaluate the bonds, and investors an opportunity to place bond orders. Getting there will require a great deal of work and buy-in, and the model has its critics.

Some are concerned that individual retail investors may not be knowledgeable about the product offerings, and that the company is targeting bonds to a group least likely to benefit from the tax-exempt benefits of municipal bonds. In addressing these concerns, Neighborly insists that it doesn't take investor education lightly. As Denver and Vancouver did, Neighborly develops materials that the average citizen can understand. The company says its intention is to make municipal bonds available to non-accredited investors who are interested in the investing in their communities but haven't been able to do so through the traditional mode of municipal bonds.

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CONCLUSIONS

The renewed interest in government-issued mini-bonds and offering low-denomination municipal bonds to retail investors can be an effective way to improve community engagement. Yet, the care that Denver and Vancouver applied to mitigate the financial risk for their citizens/investors shows that it can be a balancing act. Platforms like Neighborly also add questions about how the market for municipal bonds is changing. Only time will tell how this will pan out, but as the stories of Denver, Vancouver, and Neighborly indicate, there is a direct role for the public in this new wave of public finance. More importantly, there is a community connection.

Notes

1. "2013 Report Card for America's Infrastructure," American Society of Civil Engineers (http://www.infrastructurereport-card.org).
2. Alan Anders and Sumant Inamdar, "New York City and Retail Bond Order Periods: Getting to the Core of Big Apple Finance," *Government Finance Review* December 1999.
3. 2014 Denver Mini-Bonds, Common Questions, City of Denver, Colorado, Department of Finance (https://www.denvergov.org).
4. Jon Murray, "Denver's $500 "mini-bonds" sell out in first hour, raising $12 million," *The Denver Post*, April 27, 2016.
5. Paula Moore, "City's first minibond issue pays off," *Denver Business Journal*, updated Sunday, October 15, 2000.
6. Colorado's Taxpayer's Bill of Rights limits the powers of public entities to borrow, requiring voter approval for many debt issuances.
7. "Better Denver Bond Program," City of Denver, Colorado (https://www.denvergov.org).
8. Denver's general obligation bonds are rated Aaa by Moody's and AAA by Fitch and Standard & Poor's.
9. At https://www.youtube.com/watch?v=Q9PWMTthtjA.
10. Mark Keierleber, "Can This Tech Startup Change the Way Schools Get Financed?," The 74, October 2, 2015.

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