

# WHAT ARE BONDS?

## BACKGROUND:

There are many different types of bonds that are bought and sold everyday in the financial markets. Below is an explanation of the basic features of a bond, as well as information about the types of bonds that impact property taxes.

Bonds are financial instruments of debt used by corporations and government agencies at the federal, state and local levels.

## GENERAL DESCRIPTION OF BONDS

Bonds are financial instruments of debt used by corporations and government agencies of all levels. An issuer borrows money from investors ("bondholders") and agrees, by written contract, to repay the amount borrowed plus interest at an agreed upon rate. The amount borrowed is referred to as the "principal" amount. Normally, bonds are repaid through semi-annual payments, consisting of interest payments, with the final payment including a return of the principal. The semi-annual payments to bondholders are called "debt service". Bonds are normally sold in denominations of \$1,000 or \$5,000 each, or multiples of these amounts.

Bonds generally have a predetermined date of maturity. The maturity date is when the principal amount of the bond is due and future interest payments cease.

When bond financing is needed, the issuer will normally sell a large quantity of bonds at once. The maturity dates are often staggered so that repayment is spread evenly across the term of the bond issued, making debt service amounts level and therefore more manageable. In those cases, bonds with shorter maturities will normally carry a lower interest rate than those of longer maturities, since the longer time frame creates more risk of repayment.

## MUNICIPAL BONDS

Bonds issued by local government agencies such as cities, counties, school districts, water districts and other special districts are called municipal bonds. The noteworthy feature of most municipal bonds is that interest is generally exempt from federal income tax, and in some cases, state income tax as well. Due to this feature, and the fact that these bonds carry little risk because of the general taxing power and stability of a government agency, interest rates on municipal bonds are generally lower than interest rates on corporate bonds. While providing a benefit of tax free income to the bondholder, this also provides an effective low cost method for financing public improvements. If you pay for municipal bonds on your property tax bill, you are also benefiting from this lower cost of financing.

## HOW BONDS AFFECT PROPERTY TAXES

There are several types of municipal bonds, each type authorized by a specific state law. Some of these bonds are issued and repaid through items collected on property tax bills:

- **GENERAL OBLIGATION BONDS.** These bonds are backed by the "full faith and credit" (taxing and borrowing power) of an agency, and are paid for by increasing local property taxes above the limit imposed by Proposition 13. Because they involve an increase in property taxes, general obligation bonds require voter approval prior to issuance. These bonds are discussed in more detail in the fact sheet entitled "What are General Obligation Bonds?" found at [www.californiataxdata.com](http://www.californiataxdata.com).
- **LAND SECURED BONDS.** These bonds are secured by special assessment or tax liens on specific pieces of land. Debt service money is generated by annual assessments or special taxes levied on the properties that benefit from the improvements financed. If money from assessment or special taxes is not adequate to repay the principal and interest when due, the bondholders have the right to foreclose on the property and sell it to pay off the bonds. Land secured bonds are used to finance public improvements that benefit a specific community or territory. Land secured bonds are normally issued as Limited Obligation bonds, which means that the sponsoring agency does not guarantee repayment through its general taxation powers.

Common forms of land secured bonds include assessment district bonds (1911 Act and 1915 Act) and Mello-Roos bonds. These bonds are discussed in more detail in separate fact sheet found at [www.californiataxdata.com](http://www.californiataxdata.com).

