A Church Extension Planning Guide

Church Bonds Are Not For Everyone

With every major building project comes the question of how best to finance the project. A combination of fund raising and a loan from Church Extension or a local financial institution is the most common approach of Disciples congregations.

Some congregations look into church bonds as another source of capital funding. Church Extension does not recommend this form of financing. However, if you are considering bond financing, it is important that you fully understand how bond financing works and what the true costs will be. Church bonds may not be a lower cost alternative, nor allow as much flexibility in the management of a congregation's financial affairs.

The Concept of Church Bonds

The concept behind church bonds is really quite simple. Loan funds are secured by the sale of bonds with various maturities and coupon rates. Bondholders are repaid, with interest, by the church borrower.

Church bonds are securities. In most states there are laws and regulations that govern the issuance of bonds, sales, and disclosure procedures. In some states, a church bond issuer must register through the state securities commission. Because of the potential time and expense of registration, most congregations choose to employ the services of a commercial bond company.

Bonds Fall into Two Categories

Church bonds fall into two categories: faith bonds and mortgage bonds. **Faith bonds** are unsecured bonds, which are based upon the confidence of the members in the financial strength of the congregation and its ability to repay. **Mortgage bonds** are secured by the first mortgage on the church property. Most church capital projects use mortgage bonds.

Church bond companies sometimes assist a congregation with structuring the bond issue and handling the upfront registration process. The congregation, however, assumes the responsibility for the sale of the bonds. This form of bond sales process is termed **directed issue**.

A **brokered issue** is one in which the mortgage broker fully underwrites the bond issue and sells the church bonds on the open market to interested investors.

Frequently, there is an agreement to combine these two concepts. The congregation sells as many bonds as possible, and the remaining bonds, if any, are purchased by the broker for resale.

'Best Efforts' Basis

Unlike corporate bond issues, church bonds are more often sold on a "best efforts" basis. This simply means that all who are involved in selling the church bonds will do their best. However, the bond issue terms continue to apply, even if less than the full amount of offering is sold. Thus, the congregation must settle for whatever is raised.

Often, the bond company will agree to underwrite the full issue or purchase the unsold bonds, which allows the borrower to receive the full proceeds. Where this occurs, the broker assumes the risk of final sale of bonds and usually requires a larger fee.

Issues to Consider Before Entering the Bond Market

Regardless of the existence of collateral or the method of offering church bonds, there are a number of issues that a congregation should consider before entering the church bond market.

1) Bond repayment arrangements may be more restrictive than other forms of financing.

To guarantee the availability of funds to pay principal and interest when due, the trust indenture establishes a **sinking fund**, generally requiring weekly deposits. Funds are collected by a trustee (usually a bank) and held in the sinking fund for payment to the bondholders at the appointed payment dates. The deposit requirements are spelled out in the bond indenture—a precise legal document that describes procedures and restitution.

Normally, the trust indenture provides a lien on the first receipts of the congregation. This means the trust indenture must be satisfied before paying ordinary expenses, such as utilities or payroll. A congregation with a history of significant cash flow variations may want to consider the potential impact of the trust indenture.

2) Demand by bondholders for early redemption can pose financial difficulties.

A bondholder, especially a member of the congregation, may find it necessary to have an early return of bond investments for a variety of reasons. For instance, this person may relocate to another community and require the proceeds to cover the moving expense.

Similarly, a bondholder may suffer a financial or health emergency, or die. In any of these situations the congregation may feel morally or be legally obligated to pay off the bondholder. In such circumstances, the congregation may be obligated to find another investor or be prepared to refund the bond proceeds.

3) A congregation may find a decision to prepay or retire bonds early is prohibited or subject to penalties.

In situations where the congregation wishes to retire the debt early, the trust indenture may restrict the timing, frequency, or amount of prepayment. The trust indenture may also impose prepayment penalties. This may limit the congregation's ability to respond to new capital needs.

4) If a congregation that is financing needs additional borrowing for capital needs, securing further funds may be more difficult.

Care must be taken to hold project costs within budget or allow for cost overruns, by increasing the amount of funds raised in the bonding program.

The existence of an outstanding bond issue may mean additional financing can be provided only through the issuance of additional bonds. In this situation, the terms may require the agreement of existing bondholders, which could delay a project or hold the congregation hostage to the interests or points of view of the bondholders.

Further, most commercial lending institutions would decline to provide additional financing along with existing bonds because the additional financing would be subordinate to the bond trust indenture.

5) The sale of church bonds by members can subject them and the congregation to additional legal risk.

Unless the bond company has agreed to purchase all of a church bond issue, members of the congregation likely will be involved in marketing the bonds. This can be a laborious task, one that can expose the congregation or members to legal risks if proper sales procedures and disclosure are not followed.

6) Decision-making may be more difficult where a church has financed through the sale of bonds.

A congregation with an outstanding bond issue must take its restrictions into account whenever important decisions are to be made that might impact the congregation's ability to service the indenture. Where a small number of members hold a large percentage of the bonds outstanding, relational considerations may also arise, particularly if the bond holder has a point of view opposite other members.

7) Bonds may limit a congregation's options in times of financial difficulties.

Loan terms are not easily renegotiated and cannot be altered without the approval of all bondholders. Where the bonds have been brokered, such approval is nearly impossible and can severely impair a church's ministry.

8) The actual cost of financing is generally greater than the stated rate of the bonds.

Bonding companies often market church bonds on the basis of the average interest rate of bonds offered with various maturities. The true cost of financing, however, is based upon all costs, including the upfront underwriting fees amortized throughout the life of the debt. Because some of the fees associated to church bonds are fixed, church bonds may be cost-prohibitive for smaller projects.

For example, a $500,000 bond issue that includes bonds of 3-, 6-, 9-, 12-, and 15-year maturities at coupon rates of 6.5%, 6.75%, 7.0%, 7.5%, and 8.0% might be presented to a congregation as a bond issue with an average rate of 7.15%—this is simply an average of the five coupon rates. However, to fully repay the debt the congregation is required to make weekly payments of $1,067. Assuming no other cost factors, the effective rate paid is 7.48%.

Depending upon the nature of the bond program (which generally considers the bond company's direct involvement and risk), the underwriting costs can be 3%–12% of the bond issue. These costs are paid from the first proceeds of bond sales and are often included in the amount financed. If one assumes a fee of 4.5% is to be paid to the bond company, the effective interest rate in the example above increases to 8.23%.

Further, because the upfront fees are discounted and paid from the bond sale, prepaying the bonds further increases the effective cost of financing. If the preceding example were paid in 12 years rather than 15, the effective interest rate could increase to 8.87%. Thus, as these examples reflect, advertised rates do not accurately reflect the true cost of financing.

State securities filing fees, legal expenses, title and trust fees are additional upfront costs that must be considered. However, these are generally similar in nature to typical loan closing costs. It is important to note, however, that fees to the sinking fund trustee continue throughout the life of the bond issue and must be considered in the cost of financing.

9) The timing of bond payments also can increase the cost of financing.

Payment of bonds semiannually means the outstanding balance is not being reduced as monthly escrow deposits are made. This means a greater loan balance throughout much of the payment period than would be realized in other forms of financing, hence, greater cost.

10) Bonding companies are not created equal.

As in all financial and business dealings, one should know who will be underwriting or brokering the church bonds. Some bond companies are financially strong and reputable while others are less so.

A bonding company earns commissions off the top, based upon the size of the bond issue. Thus, it may have less incentive to hold the size of the bond issue to a level the congregation can truly afford.

Church bonds may be the route your congregation pursues, following conscientious evaluation. If so, be sure to carefully consider your needs and debt retirement capacity. And be wary of any bond companies that encourage excessively large programs for their own benefit.

Consider Other Options

Church bonds, in certain instances, can serve a congregation well as a way to finance a capital project. However, as with any financial arrangement, a congregation should carefully weigh the overall costs—both financial and administrative.

Often costs are far greater than advertised, and bond terms can sometimes limit a congregation's future options. Church Extension recommends that a congregation first take a look at traditional mortgage financing, whether through Church Extension or a local bank.

Some congregations consider church bonds a way to further involve members in the funding of a capital project. This is seen as a way for church members to use investment funds to support their congregation.

The stewardship of investments is an important element of one's Christian witness. Church Extension's Loan Support Plan is a way for members to participate in the capital funding process, earn a favorable investment rate, and provide a rebate to the congregation, without any of the limitations that may arise with church bonds.

Church Extension encourages borrowers to consider using the Loan Support Plan. Contact us for further information about LSP.

Planning Guide

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Additional Planning Guides addressing a variety of facility planning issues are available from:

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