



## BEST PRACTICE

### **Analyzing and Issuing Refunding Bonds (1995 and 2010) (DEBT)**

**Background.** Bond refinancing (“refunding”) is an important debt management tool for state and local government issuers. Refundings are commonly executed to achieve interest cost savings, remove or change burdensome bond covenants, or restructure the stream of debt service payments to avoid a default, or in extreme circumstances, an unacceptable tax or rate increase.

We have defined the following key terms and definitions in order to effectively evaluate a refunding candidate:

- Optional Call Provision / Optional Call Date
- Current vs. Advance Refunding
- Escrow Defeasance Portfolio
- Legal vs. Economic Defeasance

**Optional Call Date** - Most municipal bond issues are structured with an Optional Call Provision, which allows the issuer to refund/refinance the existing bonds by purchasing the outstanding bonds at a pre-determined price (e.g. 101%), and replacing them with new refunding bonds. The Optional Call Date is typically 10 years from the date of issuance of the bonds.

**Current vs. Advance Refunding** - There are two types of refundings, as defined by Federal Tax laws; a current refunding in which a refunding takes place (i.e., refunding bonds are sold) within 90 days of the optional call date, and an advance refunding in which refunding bonds are sold more than 90 days prior to the first call date.

**Escrow Defeasance Portfolio** - The mechanics of a refunding are the same in both cases: issue refunding bonds in an amount sufficient to generate proceeds to fund an Escrow Defeasance Portfolio. The Escrow Defeasance Portfolio or refunding escrow consists of a combination of cash and securities that are sufficient to pay the escrow requirement: the debt service, call premium, and outstanding principal of refunded bonds due on the optional call date.

**Legal vs. Economic Defeasance** - A legal defeasance typically occurs when an Escrow Defeasance Portfolio is funded with either State and Local Government Series securities (“SLGS”) or securities that are direct obligations of the U.S. Government. An economic defeasance occurs when the refunding escrow is funded with permitted investments that do not meet the defined criteria of a legal defeasance, such as Federal Agency securities (“Agencies”) or other typically higher-yielding securities. In a legal defeasance, the refunded bonds are legally removed from the issuer’s balance sheet, while under an economic defeasance the refunding bonds may remain on the balance sheet.

**Recommendation.** At the outset of evaluating each refunding, the Government Finance Officers Association (GFOA) encourages issuers to solicit the advice of their bond counsel and financial advisor in order to outline key legal and financial issues.

There are three key concepts that must be taken into consideration when evaluating a refunding candidate:

1. Financial and Policy Objectives
2. Financial Savings / Results
3. Bond Structure and Escrow Efficiency

Financial and Policy Objectives - Refundings may be undertaken for a number of financial and policy objectives, including to achieve debt service savings, eliminate restrictive bond/legal covenants, restructure the stream of debt service payments, or achieve other policy objectives.

Although in most circumstances issuers may undertake a refunding to obtain economic savings, issuers may refund an issue to restructure their debt portfolio in order to obtain budgetary/cash flow relief or to address exposure to other Government Finance costs/liabilities.

Financial Savings / Results - The GFOA recommends that issuers develop formal policy guidelines in their debt management policies to provide a financial framework for decision makers regarding the evaluation of refunding candidates

Formal policy guidelines:

- offer a systematic approach for determining if a refunding is cost-effective,
- promote consistency with other financial goals and objectives,
- provide the justification for decisions on when to undertake a refunding,
- ensure that staff time is not consumed unnecessarily in evaluating refunding proposals,
- ensure that some minimum level of cost savings is achieved, and
- reduce the possibility that further savings could have been achieved by deferring the sale of refunding bonds to a later date.

If a refunding is undertaken to achieve cost savings, the issuer should evaluate:

- issuance costs that will be incurred and the interest rate at which the refunding bonds can be issued,
- the maturity date of the refunded bonds,
- call date of the refunded bonds,
- call premium on the refunded bonds,
- structure and yield of the refunding escrow, and
- any transferred proceeds penalty.

One test often used by issuers to assess the appropriateness of a refunding is the requirement specifying the achievement of a minimum net present value (NPV) savings. A common threshold is that the savings (net of all issuance costs and any cash contribution to the refunding), as a percentage of the refunding bonds, should be at least 3-5 percent. This test can be applied to the entire issue or on a maturity-by-maturity basis. In addition, issuers may establish a minimum dollar threshold (e.g. \$100,000 or \$1 million NPV savings).

It is important to note that federal tax law typically permits an issuer to conduct one advance refunding over the life of a bond issue. As such, an issuer must take greater care (i.e., require a higher savings threshold) when evaluating an advance refunding candidate.

In certain circumstances, lower savings thresholds may be justified. For example, when an advance refunding is being conducted primarily for policy reasons (other than economic savings), interest rates are at historically low levels or the time remaining to maturity is limited, and as such, future opportunities to achieve greater savings are not likely to occur.

Savings also can be evaluated by additional metrics, such as compared to the optional call value and to historical interest rate trends. Financial analysis of refunding candidates must take into account a number of financial variables. GFOA recommends that issuers utilize an independent financial advisor to assist in performing such analyses.

Bond Structure and Escrow Efficiency - Debt management practices should anticipate the potential for refundings in the future. When bonds are issued, careful attention should be paid to the bond structure to address features that may affect flexibility in the future.

Some examples of such sales practices are:

- optional redemption provisions,
- bond coupon characteristics
- giving up call rights for certain maturities in exchange for a lower interest rate on the bonds,
- call provisions that permit the redemption of bonds in any order of maturity or on any date,
- call provisions that permit the issuer to call bonds at the earliest date without incurring a significant interest-rate penalty, and
- coupons on callable bonds priced as close to par as possible at the time of original issue.

Finally, it is important to create a refunding escrow that is efficient and will optimize savings. An escrow is efficient if escrow securities mature or pay interest when debt service payments of the refunded escrow are due – the lower the cost of the escrow (assuming all legal and permitted investment guidelines are met) the more efficient the escrow.

Issuers may purchase escrow securities in the open market or State and Local Government Securities (SLGS), a special series of U.S. Treasury securities, as well as other permitted investments, and/or use a hybrid structure. In addition, issuers may consider implementing an economic defeasance, as opposed to the standard legal defeasance.

Each option must be evaluated, considering the yield of the escrow securities and the effect of any inefficiency.

Among the issues that should be considered with regard to each type of instrument are the following:

- SLGS can be structured to comply with the federal tax law limits on investment return on escrow securities and eliminate any inefficiency in the escrow.
- Open market securities may have a higher return but may not mature or pay interest on the date when debt payments are due.
- Other permitted investments may provide even higher yields, resulting in greater savings, but often do not allow issuers to meet the requirements for a legal defeasance.

Finally, issuers may be required to increase the issue size or blend higher- and lower-yielding securities to comply with yield-restriction requirements and generate sufficient revenues. Such inefficiency may be eliminated by future escrow substitutions. Additionally, forward supply agreements, guaranteed investment contracts, or float contracts also may be considered to minimize escrow inefficiencies. However, issuers need to be concerned with potential counterparty risk, with these investment instruments.

## **References.**

- GFOA Best Practice, Investment of Bond Proceeds, 2007.
- GFOA Best Practice, Debt Management Policy, 2003
- *Debt Issuance and Management: A Guide for Smaller Governments*, James C. Joseph, GFOA, 1994.
- “Understanding Current and Advance Refundings,” *Government Finance Review*, April 1992.

Approved by the GFOA’s Executive Board, February, 2011.