

# **Bond Case Briefs**

*Municipal Finance Law Since 1971*

---

## **Alternatives to Tax-Exempt Advance Refundings Would Cost Issuers.**

WASHINGTON — Halting tax-exempt advance refundings at the end of the year, as proposed by both pending tax bills, would increase issuers' costs, deprive them of savings for new projects, and push some to enter into swaps that could increase their risk.

Market experts say there are alternatives to advance refundings, many of which have been used since Congress, in the 1986 Tax Reform Act, barred private activity bonds from being advance refunded and limited governmental and 501(c)(3) bonds to one advance refunding.

These include taxable refundings, shorter or more frequent calls, current refundings, forwards, options, and forward-starting, interest rate swaps.

While muni market participants are fighting to save tax-exempt advance refundings, it may be hard for them to make headway on this front since tax bills in both the House and Senate are aligned against retaining these bonds after 2017.

Advance refundings are used most often by issuers to lower their borrowing costs. When interest rates drop, outstanding bonds with relatively high interest rates can be advance refunded.

Refunding bonds are issued at the lower interest rate and their proceeds are used to purchase securities, typically state and local government series securities or U.S. Treasuries, which are put into escrow until the call date of the bonds being refunded when the escrowed investments can be used to take the bonds out of the market.

Advance refundings also can be used by issuers to: lengthen the average maturities of existing debt to reduce annual debt service; refinance certain types of projects to facilitate a merger or; do away with outdated or unwanted covenants in bond documents.

Halting tax-exempt refundings would be costly for muni issuers, most market sources agree.

"Eliminating tax-exempt advance refundings eliminates the issuer's ability to realize the full tax-exempt savings and lock it up prior to the call date of the bonds to be refunded," said Dave Caprera, of counsel at Kutak Rock in Chicago.

"It's going to cost state and local governments a bunch of money — and ultimately taxpayers," said Kurt Freund, a managing director at RBC Capital Markets in Phoenix.

"It's going to raise the cost of issuance," said Tom Dannenberg, president and chief executive officer of Hutchinson, Shockey, Erley & Co. in Chicago.

Dannenberg said it will take away an issuer's ability to both easily lower debt service costs and free up additional borrowing capacity for other much-needed projects.

Prohibiting advance refunding bonds could also shrink the market.

The par amount of tax-exempt advance refundings done in 2016 was more than \$120 billion, almost 27% of the new long-term issue market, according to data from Thomson Reuters (TRI). That amount has been higher in the past and varies widely year-to-year depending on interest rates.

The Joint Committee on Taxation estimates Congress will raise \$17.3 billion in revenues over 10 years by terminating advance refundings.

Dannenberg says he thinks JCT's estimates are suspect because it is assuming all tax-exempt refundings will be replaced by taxable advance refundings and he doesn't see that happening.

"If issuers can't do tax-exempt refundings, they won't simply do taxable advance refundings," he said.

The tax bills' provisions also have a retroactive impact in that issuers that sold bonds in recent years with the expectation that they will be able to advance refund them with tax-exempts will no longer be able to do so, George Friedlander, managing partner at Court Street Group Research, pointed out in a recent paper.

The bills have caused many issuers to push up tax-exempt advance refundings to November and December of this year before they are foreclosed from doing so.

But there are alternatives. For outstanding bonds, sources said, issuers can do taxable advance refundings, if they still produce savings. Issuers can also do tax-exempt current refundings, which must be done within 90 days of the call date. Current refundings would still be permitted by the tax bills.

Offerings for new bonds can be structured with shorter or more frequent call dates, forward or option contracts, and forward-starting interest rate swaps.

Freund said some issuers can still save money doing taxable refundings, depending on how high the interest rates are on the bonds to be refunded and current interest rates.

"Right now we're analyzing and I would imagine others are analyzing — if they're not they should be — whether it makes sense to do a tax-exempt refunding before the end of the year or a taxable refunding in February," he said.

A taxable refunding would permit "a little bit less onerous pace going forward with the financing" and could still result in savings, albeit not as much savings as would result from a tax-exempt advance refunding, he said.

Issuers can also "do current refundings, I think that will happen for sure, going forward," said Freund.

Chris Hamel, managing director and head of municipal finance at RBC Capital Markets in New York, said current refundings have become popular in recent years with low interest rates as a way to minimize negative arbitrage.

If interest rates are so low that an issuer's investment yield from the securities it's escrowed in a refunding is lower than the yield on its refunding bonds, then the issuer is stuck with negative arbitrage that eats into its savings. With a current refunding, the escrow is only in place for 90 days or less, minimizing the negative arbitrage.

RBC provided The Bond Buyer with statistics showing current refundings last year were 23% of the market, compared to 26% for advance refundings. In 2015, current refundings were 30%, compared to 22% for advance refundings.

New bonds can be structured with shorter calls or more frequent calls than the standard 10-year call, market sources said.

"Right now short calls cost a lot," said Friedlander. He said he doesn't see the market going to five-year calls, at least for now, because "the extra yield investors will want will be too much for issuers."

But Hamel said bank-qualified bonds in Pennsylvania, Nebraska, South Dakota and other states already have five-year calls. "It's not as if this doesn't already exist" in some parts of the market, he said.

And Freund said that while typically right now, "the earlier the issuer makes the call, the more the issuer will pay for it," markets "evolve over time."

"Five years from now people may only do five-year calls," and costs won't be as high as going with a five-year call today, he said.

Freund said it depends on the market and the maturity. "Right now, in many circumstances you can price an eight-year call at about the same as a 10-year call for a high-yield piece of paper," he said, adding "but not in all markets all the time."

Issuers also can enter into derivative products such as long bond purchase agreements, forwards, options, and forward-starting interest rate swaps, to achieve some, but not all of the savings they would have gotten from a tax-exempt advance refunding, sources said.

"I think another product you'll see people use, I would suspect, are contracts for forward delivery of bonds," said Freund.

An issuer may have bonds with a call date of July 1, 2022, he said. Ninety days before that call date would be April 1, 2022. The issuer might sell bonds six months before call date, price them and sell them to investors, but delay the delivery date of the bonds until April 1, 2022 when it could do a current refunding. The issuer has locked in low interest rates with a little bit of premium. It's hedging against interest rate increases and paying for that, said Freund.

"These are all techniques we saw the market adopt after the 1986 limitations on advance refundings and they still can be used," said Sam Gruer, managing director of Blue Rose Capital Advisors. "New products will be developed. The industry as a whole is very innovative."

Billions and billions of dollars of forward-starting interest rate swaps were done in the late 1990s and early 2000s by issuers who were prohibited from doing any, or any more advance refundings, Gruer said.

In a forward starting swap, an issuer enters into an interest rate swap that doesn't take effect for several years. Here's how it worked.

A state sold governmental or 501(c)(3) bonds in the early 1990s and advance refunded them in 2002. These refunding bonds were callable in 2012. In 2007, interest rates dropped even further and the state wanted to advance refund them again, but was prohibited from doing so by the Tax Reform Act of 1986.

So the state entered into a floating-to-fixed, forward-starting swap agreement with a dealer in 2007 that locked in the low interest rates from that year but didn't take effect for five years or 2012, when the refunding bonds could be called. Under the agreement, the state would pay fixed rates and receive floating rate payments from the bank or dealer acting as the swap counterparty.

The state also issued floating rate bonds in 2012. The floating rate from the swap and floating rates of the bonds canceled each other out. The state was left with a synthetic fixed rate bond that it used to current refund the 2002 refunding bonds when they became callable in 2012.

A variation of this structure was for the issuer to pay higher rates on the swap when it takes effect, in order to get some of all of the payments upfront from the bank or dealer swap counterparty.

Gruer said forward-starting swaps "need to be analyzed carefully and maybe it's appropriate for some issuers but not for others."

He said some of these transactions cost issuers during the financial crisis when banks raised prices for letters of credit backing variable rate bonds and then stopped issuing them altogether. Under those LOCs if the bonds couldn't be remarketed the bank would have to buy them.

Money market funds at that time would only buy the bonds if they were backed by LOCs. That's because bonds backed by liquidity facilities were in trouble. Under those agreements banks agreed to buy bonds that couldn't be remarketed if the bonds were backed by an insurer rated triple-A. While the insurers were historically rated triple-A, they were all downgraded during the financial crisis.

By Lynn Hume

BY SOURCEMEDIA | MUNICIPAL | 11/22/17 07:33 PM EST

Copyright © 2024 Bond Case Briefs | [bondcasebriefs.com](http://bondcasebriefs.com)