

Bond Case Briefs

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The Art and Science of Prepaying Bonds.

It is always a good thing when you can replace your existing home mortgage loan with one having a lower interest rate. My original mortgage loan in 1981, for my house I still live in, had an interest rate of 16.25%. Fortunately, I was able to refinance it a few times into lower and lower interest rates, and finally - one of the few benefits of getting older - I paid it off!

If you are a governmental entity, the same thing is true when you refund your existing bonds with lower interest rate refunding bonds. In 1981, tax-exempt municipal bonds were bearing interest at 13%. For a governmental issuer, the ability to prepay debt is one of the most important terms in a financing; the issuer should look askance at any structure that materially limits the ability of the issuer to refinance its debt.

First Call Date. The ability of the issuer to prepay bonds is referred to in the legal documents as an “optional redemption.” There are certain basic conventions. A bond issue typically has a “no call” period during which the bonds cannot be optionally redeemed. In most cases the “first call date” is about 10 years after the bonds are issued. In my state of Pennsylvania, small bond issues under \$10 million in principal amount often have a five-year first call date. This “no call” period ensures the bond purchaser that it will be able to take advantage of its interest rate for a minimum set period of time without worrying about having its bond optionally redeemed by the issuer.

The Price of the Call. Most municipal bonds, when they reach their first call date, are redeemable “at par.” That means the bonds are prepaid at 100% of the principal amount plus any accrued interest to the redemption date. Some bonds, particularly for issuers with lower credit ratings, are prepayable at “par plus a premium.” For example, a nursing home bond issue may have a 10- year no call period, then be callable at 103% of principal amount in year 11, 102% of principal amount in year 12, 101% of principal amount in year 13, and at par in year 14 and thereafter (in all cases plus accrued interest to the redemption date). From the issuer’s perspective, a redemption premium makes the refunding more expensive and requires rates to go even lower before a refunding makes economic sense.

Issuer Beware: Noncallable Bonds. In the world of finance, everything has a price. If you as an issuer are willing to forgo any optional redemption right (that is, the bond purchasers know their bonds will never be optionally redeemed), then you will probably be able to sell your debt at lower interest rates than an issue with a normal call feature. That is initially good for the issuer, but the issuer will never be able to take advantage of potentially even lower rates in the future. There is nothing more frustrating to an issuer than to have noncallable, high interest rate bonds in a declining interest rate environment.

Issuer Beware: CABs. In the late 1990’s the hot technique du jour was capital appreciation bonds or “CABs”. Normal fixed- rate municipal bonds pay accrued interest semiannually. CABs have no periodic interest payments. Interest accrues on the CABs, but the principal amount and all accrued interest are not payable to the bondholder until the maturity date of the bond. CABs are noncallable and they carry a “yield penalty” to the issuer (the investor wants higher interest to compensate for no payments received prior to maturity). After the CABs are issued, if you are an issuer who needs to

pay off its existing debt (to eliminate a trust indenture with problematic covenants, or to be able to sell a sewer system financed with the CABs), the existence of your CABs is a major financial and legal headache.

Issuer Beware: Make-whole calls. The corporate bond world has different prepayment conventions. Rather than pricing a call at par or at par plus a fixed percentage premium, corporate bond calls are usually priced using a “make-whole” premium. The premium is calculated using a formula that gives the bondholder the benefit of a declining interest rate environment. If the rate environment is declining, then the amount of the make-whole premium increases when the issuer optionally redeems the bond. This is essentially the deal: “Go ahead issuer, you can optionally redeem this bond, but you will do so at a price that will make the bondholder whole based on current market conditions. That means you will lose the savings you would otherwise achieve in the refunding.”

Governmental issuers sometimes find it advantageous to issue taxable bonds rather than tax-exempt bonds (usually because certain uses of bond proceeds do not conform to the tax-exempt bond regulations, or because the issuer wants to do an advance refunding it cannot do on a tax-exempt basis (see below)). In such cases, their call features will usually employ the make-whole prepayment structure, because the potential bond purchasers are used to, and want, the corporate bond structures. But if a governmental issuer is issuing tax-exempt debt, it should be wary of anyone who recommends using a make-whole prepayment structure. This is particularly true when an issuer is obtaining a tax-exempt loan from a bank – often the bank will ask for a make-whole prepayment structure.

Issuer Beware: Synthetic fixed-rate bonds. In the decade after the heyday of CABs, the new product du jour was interest rate swaps. Where do I begin on this topic? Here was the pitch: “Hello, issuer – instead of issuing regular fixed rate bonds at 5.00%, issue variable rate bonds and enter into a variable-to-fixed rate interest rate swap, and you will end up with a “synthetic fixed rate” of 4.75%.” These structures were based on certain market assumptions and involved novel risk allocations. When the Great Recession hit in 2008 and 2009, the market assumptions went kaput, and supposedly “remote” risks came home to roost with a vengeance on issuers. For purposes of this article, the relevant point is: interest rate swaps can be very expensive to get out of. If the issuer wants to terminate a swap, it could have to pay a large termination fee calculated in a similar fashion to the make-whole calls described above. It may make it practically impossible to prepay the variable rate bonds and associated swap.

The Important Point: Issuer beware. I am a bond lawyer not a municipal advisor. I do not pretend to understand all the mathematical and market nuances involved in these matters. But I have seen issuers be seriously hamstrung by bonds that do not have traditional fixed-rate bond prepayment features. Issuers should be wary of anyone who shows up at their door selling “noncallable bonds” or “CABs” or “make-whole calls” or “interest rate swaps” or “synthetic fixed rate bonds.” This does not mean that these products are always bad. They might be good in specific situations for specific issuers. But they can be so complicated that the issuer is unlikely to know the difference between good and bad without assistance. If you, as an issuer, hear these magic words uttered, it is time to call in your municipal advisor to help you sort through them. And if you are dealing with a swap, make sure your municipal advisor has expertise in swaps as well as bonds.

Variable-rate bonds. Most of the concepts described above relate to fixed rate municipal bonds. In the 1980s, municipal issuers, tired of high fixed rates, started issuing variable rate bonds. These bonds typically can be put on short notice by the bondholders to the issuer to be remarketed, and they bear interest at a much lower variable rate. Variable rate debt is typically prepayable by the issuer at par plus accrued interest at any time with no “no call” period. But the variable rate debt

can become difficult to prepay if it is tied to a swap (see synthetic fixed rate bonds above).

The issuer should also consult closely with its municipal advisor on any variable rate debt structures. There was a Wall Street-created variant of variable rate debt called “auction rate bonds” that went completely kaput in the Great Recession. Once again, issuer beware!

Bond Pricing and Prepayment. When fixed rate bonds are priced during their initial issuance, they can be sold at par (at 100% of principal amount), at a discount (less than 100% of principal amount) or at a premium (over 100% of principal amount). The rate on a bond is called the “coupon rate”. A bond sold at a discount may have a coupon rate of 4.00%; but because the bondholder buys it at a discount (less than 100 cents on the dollar), the bond has a yield to the bondholder higher (say, 4.10%) than the coupon rate. A bond sold at a premium may have a coupon rate of 4.00%; but because the bondholder buys it a premium (more than 100 cents on the dollar), the bond has a yield to the bondholder lower (say, 3.90%) than the coupon rate.

Many municipal bonds are purchased by municipal bond funds. For reasons related to the marketing of those funds, the funds do not like to buy bonds with low coupon rates. So, the funds may say, “I want to buy this bond at 4.00% even though the market rate is lower, and I’m willing to pay a premium to buy the bond at that coupon rate.” With rates going lower and lower in the last few decades, many refunding bonds have been marketed with relatively high coupon rates and lots of premium. As a result, when five or 10 years later we come up to the first call date, the artificially high coupon rates on the existing bonds means they can be refunded at a substantial savings. That is why, even if market rates went lower in small increments over the five to 10 years, the savings could still be substantial.

Current Refundings and Advance Refundings. A current refunding is a refunding in which the refunded bonds are redeemed within 90 days of the issuance of the refunding bonds. An advance refunding is a refunding in which the refunded bonds are redeemed more than 90 days after the issuance of the refunding bonds. In either case, the redemption usually occurs as soon as possible after the refunded bonds’ first call date.

When an advance refunding occurs, for a period of time until the first call date on the refunded bonds, there are two sets of bonds outstanding with respect to the original project. So, if an issuer issues \$10 million of bonds with a ten-year call to finance a capital project, and then four years later issues \$10 million of bonds to advance refund the original bonds, the result is that for the next six years there are about \$20 million of bonds outstanding relating to a \$10 million capital project. If both series of bonds are tax-exempt, the U.S. Treasury hates this – bondholders are getting twice the tax-exempt interest benefit they should be getting for a \$10 million project.

When I was a young bond lawyer in 1981, I told the senior partner I worked for that I was nervous because we were doing so few bond deals that year. He told me, “Don’t worry, Dave, every new deal we do in this 13% interest rate environment, we will be able to advance refund three or four times over the next decade.” I remember one advance refunding deal in which, between the sale date and the closing date, interest rates were taking such a dive that it already made sense to advance refund the advance refunding bonds we had not yet closed.

The U.S. Treasury and Congress clamped down on tax-exempt advance refundings, first in the 1986 tax act, and then again a few years ago to totally eliminate them. There is now a movement in Congress to liberalize the advance refunding rules again. Back to the future.

Issuers should recognize that their ability to prepay debt they are entering into is an extremely important term, and they should consult with their municipal advisors to achieve the most liberal

prepayment term consistent with the type of financing they are doing. This becomes important when, down the road, the issuer wants to take advantage of a lower interest rate environment, or the issuer needs to get out of certain existing debt for other business reasons.

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