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How States and Cities Lost Billions Refinancing Their Debt Early.

- **Issuers would have saved more money by waiting until call date**
- **Massachusetts says debt managers don't have 'crystal ball'**

A popular bond refinancing tactic used by US states and cities likely cost taxpayers "billions of dollars," according to a paper to be presented July 18 at the Brookings Institution's 12th annual municipal finance conference.

The study analyzed 14 of the more than 200 so-called advanced refundings in which tax-exempt municipal bonds were refinanced with taxable debt between 2018 and 2020. Those 14 borrowers alone, including the state of California and the New York State Thruway Authority, left about $580 million on the table because they opted to refinance early instead of waiting until the call date when they could refund them using tax-exempt bonds, which have lower yields.

Combined, the savings lost on the more than 200 transactions is likely to amount to billions of dollars, said the study's authors Andrew Kalotay, president of Kalotay Advisors, and Martin J. Luby, an associate professor at the Lyndon B. Johnson School of Public Affairs at the University of Texas at Austin.

Issuers likely proceeded with taxable advanced refundings because of the concern that interest rates would rise, the authors wrote. Instead, rates fell even further as the Federal Reserve cut interest rates to zero to bolster the economy amid the Covid-19 pandemic.

"They speculated and lost a lot of taxpayer money," Kalotay said in an interview.

Municipalities, for their part, said the analysis was distorted by the Federal Reserve's response to the pandemic and omitted more favorable deals. For example, in 2020, the Massachusetts School Building Authority issued 10-year taxable bonds yielding 1.75% to advance refund debt issued in 2012. If the agency waited to refinance until the bonds were callable in Aug. 2022, 10-year tax-exempt yields would have been about 2.25%.

Lower Costs

To fund roads, bridges, schools and sewers, states and cities typically issue 30-year municipal bonds with fixed coupons that are callable at par in 10 years. To lower borrowing costs or postpone debt payments, municipalities can undertake an advance refunding. They issue new bonds in advance of the date when the securities can be redeemed and use the investment income to cover the cost of the outstanding debt until it could be called back.

Until 2017, municipalities could use lower cost tax-exempt debt for advance refundings. State and local borrowers used the tactic because they frequently issued debt with premium 5% coupons — far above prevailing interest rates — and refinancing could generate savings.

(Higher coupon bonds appeal to institutional investors, like mutual funds, because their prices fall less when interest rates rise and they have better liquidity. And the higher coupons give holders the ability to reinvest larger amounts of semi-annual interest payments, particularly helpful in a rising rate environment.)

In late 2017, the Republican Tax Cuts and Jobs Act prohibited the sale of tax-exempt bonds for advanced refundings as a way to offset revenue loss from the cuts. The nonpartisan Joint Committee on Taxation estimated at the time that ending advance refundings would mean an additional $17.3 billion in revenue to the federal government over 10 years.

Record Lows

But Congress didn't ban advance refundings using taxable bonds. With interest rates near record lows at the time, municipalities rushed to issue taxable securities to generate savings. States and local governments issued about $116 billion of taxable munis for advanced refundings between 2018 and 2020, according to data compiled by Bloomberg.

One of those issuers was the Massachusetts School Building Authority.

In November 2019, the authority issued taxable bonds to advance refund about $750 million of tax-exempt exempt debt issued in 2011, saving the state $121.6 million, according to Kalotay and Luby. (The state pegged the savings at $135 million, according to a December 2019 memo)

After the deal, yields on benchmark 10-year tax-exempt muni bonds declined as the Federal Reserve lowered interest rates to zero to limit the economic damage of the pandemic. By the Nov. 1, 2021 call date of the 2011 bonds, yields fell to 1.22% from about 1.52%.

Had the state agency waited until Nov 2021 and called the 2011 bonds at par from investors and issued tax-exempt debt, Massachusetts would have saved more than $221.6 million, according to the study.

Crystal Ball

Andrew Napolitano, a spokesman for Massachusetts State Treasurer Deborah Goldberg, said state officials have to make decisions in real time, and couldn't have foreseen the Covid-19 pandemic or the Federal Reserve's unprecedented response.

The state's debt managers "do not have a crystal ball when considering its debt portfolio management strategies or future market conditions," Napolitano said. In addition to savings, Massachusetts also considers factors such as investor demand and impact on the current debt portfolio.

New York's Thruway Authority said its 2019 advanced refunding was part of larger plan to improve operations and debt structure. Had last year's rapid rise in interest rates come sooner, waiting to the call date to refinance its bonds would likely have produced less savings than a taxable advanced refunding.

"Any decision made in the financing arena is dependent upon market conditions at the time in conjunction with current plans or needs, as well as the ability of information," the Thruway Authority said an emailed statement. "To simply lump together transactions to support a conclusion well after the fact may not be an accurate depiction of that conclusion."

The California Treasurer's office didn't respond to a request for comment.

Issuers would have made better decisions is they had compared the estimated savings of their advanced refundings to the value of the call options they would forfeit, Kalotay and Luby wrote. Municipalities shouldn’t refinance early unless the ratio is at least 90%. The efficiency of the typical taxable refunding was barely 70%, they said.

“Nobody knows where interest rates are going, but you can use mathematics to say, ok, what’s the probability they go here or there,” Kalotay said.

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