Restructuring Debt Service

A substantial amount of long-term debt issuance (over 50 percent in recent years) consists of debt issued to refund other existing outstanding debt. In simple terms, new debt is issued to pay off old debt, normally to achieve cost savings associated with lower interest rates.

Advance vs. Current Refundings. There are generally two types of refundings that are used. In an advance refunding, the issuer sells new bonds and places the proceeds into an escrow account. These proceeds, along with the interest earnings that result from their investment, are used to pay off the bonds at their scheduled maturity or first call date (which is more than 90 days after the date of issuance of the refunding bonds). Federal tax law generally provides that a bond issue may be advance refunded only once (although bonds issued prior to 1986 may be advance refunded twice). Issuers should be comfortable that the savings to be generated by the advance refunding if it is done now significantly exceed the potential savings that could be generated if it is done at a later date—possibly in a more favorable interest rate environment.

A current refunding is a transaction in which the outstanding bonds to be refunded are called and paid off within 90 days of the date of issuance of the refunding bonds. There is no federal limitation on the number of times that a bond issue can be refunded on a current basis. For a general discussion of the rules applicable to refundings, see **Chapter 3, General Federal Tax Requirements – Refunding Bonds**.

There are a number of reasons issuers may wish to restructure their debt, including:

- **Achieve Cost Savings**. The primary reason issuers refund their debt is to achieve cost savings by replacing debt issued in higher rate environments with debt issued at lower rates. Issuers typically seek to achieve present value savings, after accounting for all expenses of sale including underwriter's compensation, relative to the debt service costs of the outstanding debt. Many issuers use present value savings thresholds in order to ensure that the transaction generates significant savings relative to the issuer's investment of time and effort, or to ensure that the transaction is "safely in the money" given the volatility of these calculations. Common savings thresholds are 3 to 5 percent of debt service costs, on a present value basis. In some cases issuers have also insisted that these present value savings exceed the amount of compensation to be earned by all financial professionals in conducting the transaction, in order to ensure that the issuer's savings are clearly seen as the motivation for the transaction.

- **Mitigate Irregular Debt Service Patterns.** Another reason for conducting a refunding transaction is to alter the yearly debt service pattern on outstanding debt. For example, an issuer may find that it faces a "spike" in its debt service requirements in a coming year that will place a fiscal burden on its ability to maintain other programs. By refunding that debt with new debt structured to level out its upcoming expenses, that situation can be avoided.

- **Lower Annual Debt Payments.** By refinancing their debt over a longer time horizon, an issuer may be able to lower the dollar level of its annual debt service requirements. This strategy may be useful in coping with adverse changes in an issuer's financial condition.

- **Free Up Reserve Funds.** In some cases, issuers can free themselves from the requirement that a reserve fund be maintained for an outstanding bond issue through a refunding

- **Eliminate Restrictive Covenants**. Finally, an outstanding bond issue may contain restrictive covenants that interfere with an agency's ability to carry out its programs or finance another project. By issuing new debt without those restrictive covenants, the old covenants have no further effect.

Issuers also have the option to retire bonds through secondary market purchases or through optional tender programs. Under a secondary market purchase program, the issuer may use any available funds to purchase outstanding bonds from willing sellers and then retire them. Issuers may be motivated to do this by favorable market conditions that allow the bonds to be purchased at prices below par, thereby realizing savings relative to the cost of retiring those bonds on their scheduled maturity date. They also may be motivated by the desire to reduce outstanding debt in order to meet requirements for the issuance of new debt. Optional tender programs are a more formal mechanism to achieve the same goals. Under these programs, the issuer actively solicits bondholders to "tender" or turn in their bonds at specific prices, commonly conditioned upon a sufficient number of bonds being tendered.