

SESSION ONE

Market Perspective Meets Issuer Objectives



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Market Preferences

- **Coupons:**

- The Budget Reconciliation Act of 1993 changed the tax-treatment of OID accretion for municipal bonds. It also included a de minimis rule to prevent minor market fluctuations from triggering the new provisions.
- Following the financial crisis in 2008, extremely low interest rates (e.g., 2-3%, etc.) drove investor preferences for premium coupon bonds to protect their bonds from trading at a discount larger than the “safe harbor” de minimis. As a result...
 - 5% coupons have grown to become industry “standard”
 - Higher coupons (e.g., 5.25% and 5.50%, etc.) are popular in times of rising yields to provide even more price protection
 - Lower 4% coupons or par-ish bonds come at a pricing yield concession; Investor betting that bond is less likely to get called, and if called, they benefit from pricing yield concession
 - 3% and lower coupon: Investors tend to be hold-to-maturity investors who want duration and are betting their bonds will not be called for economic reasons (e.g., insurance companies who don’t need to mark positions, retail accounts, etc.)

- **Call Features:**

- Investors resigned to issuers’ demand for 10yr par call; however, they get pricing based on final maturity
- In high-rate environments, short calls come at a concession to a 10yr par call as investors expect bonds to be called when rates decline (and they take reinvest risk)
- In low-rate environments, short calls are relatively costless as investors are betting that if the bonds get called, it will likely be in a higher rate environment (than when purchased, but lower than the coupon) and hence less reinvest risk

- **Amortization:**

- Maturity Size: Prevalence and influence of ETFs have made maturity sizes of at least \$15mm and \$25mm desirable
- Maturity Range: Prevalence and influence of SMAs, whose range has extended to 20 years, have allowed for serial bonds of size
- Mega Deals: Increased cadence of mega deals (greater than \$1bn) has created the need for issuers to offer alternative coupon and call options to appeal to a broader buyer base

Needs of Issuers

- Call Feature:
 - 10yr (or shorter) par call for refunding and restructuring flexibility
- Term Structure:
 - Serial and term bonds to amortize debt across supporting rate base
- Balloon Indebtedness (Put Bonds/Extendible Maturities/VRDBs/FRNs):
 - Long-term amortization with short-term rates, to take advantage of steep yield curve

Why Are Refundings Done?

- Interest rate savings (High-to-Low Refunding)
 - Current interest rates are below prior bond's coupon; Refunding generates cashflow and/or present value savings
- Defeasances (Low-to-High refunding)
 - Refunding bonds issued to defease required portion of prior debt to release the issuer from certain covenants associated with the prior bonds
- Restructurings
 - High-to-Low or Low-to-High refundings executed to change the amount of debt service due in any given year; May or may not generate present value savings

Tools Used to Effect Refundings

- Tax-Exempt Current Refundings of:
 - Tax-Exempt Bonds, invoking a current call
 - Taxable Bonds (eligible for tax-exempt financing) invoking a make-whole call
- Tax-Exempt Advance Refundings of:
 - Tax-Exempt debt that qualifies for acquisition treatment
 - Taxable Bonds (eligible for tax-exempt financing)

Tools Used to Effect Refundings (continued)

- Forward Delivery Refundings
- Taxable Advance Refundings
- Tender Refundings
- Forward Starting Swap Refunding
- Cinderella Bonds: Taxable Bonds that convert to Tax-Exempt in the future
- Cash Optimization: Two-Step Strategy to Effect an Advance Refunding
 - Use cash, otherwise earmarked for PayGo new money, to defease prior bonds
 - Issue new money bonds to replace cash used for defeasance

Refunding Criteria

- Simple Savings/Take-It-or-Leave-It Test
 - 3% for Current Refundings/5% for Advance Refundings/0% for bonds maturing within 2 years
- Sliding Scale Test (based on Callability, or years from call date to maturity date)
 - 0-5 years: 0.5%
 - 6-10 years: 1.0%
 - 11-15 years: 3%
 - 16-20 years: 4.0%
- Rate Efficiency Test
 - PV Savings @ Current Rates vs PV Savings @ Lower Rates (e.g. Current Rates – 25bps) > Threshold (e.g. 40%)

Refunding Criteria (continued)

- Opportunity Cost Index (OCI) Test
 - PV savings from Advance Refunding/PV Savings from Current Refunding using lower rates (e.g. - 50bps) > Threshold (e.g. 70%)
- Escrow Efficiency Test
 - Negative Arbitrage/PV Savings < Threshold (e.g. 75%)
- Option Value Test
 - PV savings from Refunding/Option Value (with defined terms for calculation) > Threshold (e.g. 70%)

Other Refunding Criteria/Considerations

- No extension of debt
- PV savings = Neutral (for Restructurings)
- Cashflow savings in every year
- Savings from Refunding using Derivatives - Savings from Refunding using Traditional Fixed Rate > Threshold (e.g. 5%)
- Different Savings Criteria for refunding of Taxable Debt/BABs (e.g. 0%) vs Tax-Exempt Debt (e.g. 3%)
- Different Savings Criteria for Individual Maturities (e.g. 0%) vs Entire Series (e.g. 3%)
- Different Savings Criteria for Partial Refundings vs Whole Refundings (to ease Administrative Burden)

Refunding Strategy

- What goal(s) is your refunding achieving?
- How important are the savings today?
- What are your cashflow timing considerations?
- How does your refunding strategy affect future borrowings?
- Who are the stakeholders affected by your refunding strategy and how do you balance their considerations?
- What products/tools/financing strategies do you plan to use to execute your refunding strategy?
- Do you have the financing team (internal and external) to help you execute your financing strategy?

Sound Refunding Decisions: Beyond the Savings Metric

- No single metric can answer every refunding question
- Context matters: issuer objectives, budget needs and market conditions
- Weigh savings today against the value of preserving the call option and future flexibility
- Apply a consistent decision-making framework across transactions and rate cycles, even as individual metrics evolve
- Historical experience informs decisions but does not determine future outcomes
- Judge decisions on what was known at the time, not where rates went afterward

A New Possible Refunding Evaluation Approach

- Quantifying additional benefits of a refunding

	How Important is the Money?	Do the Savings Help with Employment?
Possible Considerations	• Will the savings fund a critical service that will otherwise be cut? • Are the savings a critical part of a larger funding plan for a major project or initiative?	• What impact do the savings have on job security or employment? • Can elected officials or staff point to the savings as compelling rationale in support of a positive job review?
Category Score	Score (1-50)	Score (1-50)
Refunding Score	Equal to the sum of the two category scores	

- If the refunding score is at least 70, then the refunding should be pursued.

QUESTIONS?



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