To Refund or Not to Refund? That Is a Popular Question.
By Steve Larson, Senior Financial Advisor

As we have noted in Ehlers’ bi-weekly Market Commentary, when interest rates reached their lowest levels in 45 years in January of this year, many governmental units scheduled sales of bonds. Refinancing, or “Refunding” of existing bonds has particularly increased since the beginning of this year. Why do local governments refund debt and what criteria should be used to determine if a refunding is appropriate?

Refundings are typically undertaken for one of two general reasons. First, to achieve lower debt service costs resulting in savings to the community. Second, to restructure debt service payments to match the revenue stream paying the debt service. A common example of debt restructuring is decreasing debt payments to account for an unforeseen reduction in revenues.

There are two types of refundings under IRS rules: current refundings and advance refundings. A current refunding occurs when the obligations being refunded are either callable (pre-payable) now, or will be within 90 days of the closing date of the new bonds being issued. An advance refunding occurs when the new bonds will be issued and close more than 90 days prior to the call date of the obligations being refunded.

Current refundings typically have lower cost of issuance expenses than advance refundings. When an advance refunding occurs, funds are placed into an escrow account and interest is earned on these funds until the bonds being refunded are paid off on the call date. An Escrow Agent and a third-party/independent CPA is required to verify the amount deposited into the escrow account is sufficient to pay off the bonds. Retaining the services of an Escrow Agent and CPA for an advance refunding, which is not required for a current refunding, is the primary reason issuance expenses are higher for an advance refunding. When a current refunding occurs, the bond proceeds are not placed in an escrow account, rather the funds are sent on the call date (typically by the Issuer) to pay off the obligations being refunded.

IRS regulations permit only one advance refunding during the life of an original tax-exempt bond issue. It is therefore important to carefully consider when and if it should be used. While an advance refunding may offer attractive savings, it may not make sense to undertake if, for example, there is a concern that the revenue stream paying the debt may decline in the future necessitating a refunding for structure at a later date. It is also important to estimate the savings if you were to wait to undertake a current refunding, so this can be compared to the savings of completing an advance refunding now. This type of
sensitivity analysis can determine how much interest rates could increase between now and the time the bonds enter their current refunding window, and still make waiting a better option.

If a refunding is pursued to achieve savings, a minimum savings threshold should be established. Generally, Ehlers recommends considering refunding when the net present value benefit of the refunding is estimated to be at least 2% of the refunded principal, with 3% or greater preferred.

Refundings should not be evaluated as an isolated event; rather they should be evaluated in the context of existing debt service payments and future capital needs. Ehlers regularly monitors clients’ debt issues to determine if there are candidates for a current or advance refunding. If a local government is planning to issue bonds for new projects, the cost of issuance can be apportioned to the “new money” portion of the bond issue and the “refunding” portion of the bond issue, potentially increasing savings for the refunding component.

Whether refundings are pursued for savings, restructuring, or both, there are many considerations to take into account to determine if refunding an existing obligation makes sense.

For more information on refunding and capital bonds, please contact Steve Larson at (630) 271-3331 or slarson@ehlers-inc.com.