



## BEST PRACTICE

### Analyzing an Advance Refunding (1995) (DEBT)

**Background.** An advance refunding is an important debt management tool for state and local government issuers. It is commonly used to achieve interest cost savings, remove or change burdensome bond covenants, or restructure the stream of debt service payments to avoid a default, or in extreme circumstances, an unacceptable tax or rate increase. Advance refundings, which are limited in number by federal tax law, must be carefully planned and undertaken to be successful.

**Recommendation.** The Government Finance Officers Association (GFOA) recommends that issuers include guidelines in their debt policies concerning advance refundings to provide guidance to decision makers. Formal policy guidelines

- offer a systematic approach for determining if an advance refunding is cost-effective,
- promote consistency with other financial goals and objectives,
- provide the justification for decisions on when to undertake an advance refunding,
- ensure that staff time is not consumed unnecessarily in evaluating advance refunding proposals,
- ensure that some minimum level of cost savings is achieved, and
- reduce the possibility that further savings could have been achieved by deferring the sale of refunding bonds to a later date.

If an advance refunding is undertaken to achieve cost savings, the issuer should evaluate

- issuance costs that will be incurred and the interest rate at which the refunding bonds can be issued,
- the maturity date of the refunded bonds,
- call date of the refunded bonds,
- call premium on the refunded bonds,
- structure and yield of the refunding escrow, and
- any transferred proceeds penalty.

One test often used by issuers to assess the appropriateness of an advance refunding is the requirement specifying the achievement of a minimum net present value savings. A common threshold is that the savings (net of all issuance costs and any cash contribution to the refunding), as a percentage of the refunding bonds, should be at least 3-5 percent.

In certain circumstances, lower thresholds may be justified, such as if the advance refunding is being done for reasons other than economic savings, interest rates are at historically low levels and future opportunities to achieve more savings are not likely to occur, and the bonds to be advance refunded are approaching their call date.

Debt management practices should anticipate the potential for an advance refunding in the future. When bonds are issued, careful attention should be paid to sales practices that will affect flexibility.

Some examples of such sales practices are

- optional redemption provisions,
- bond coupon characteristics
- giving up call rights for certain maturities in exchange for a lower interest rate on the bonds,
- call provisions that permit the redemption of bonds in any order of maturity or on any date,

- options that permit the issuer to call bonds at par at the earliest date possible without incurring an interest-rate penalty, and
- coupons on callable bonds priced as close to par as possible at the time of original issue.

Finally, it is important to create a refunding escrow that will produce the greatest savings and is efficient. An escrow is efficient if escrow securities mature or pay interest when debt service payments of the refunded issue are due. Issuers may purchase escrow securities in the open market or may purchase State and Local Government Securities (SLGS), a special series of U.S. Treasury securities. Each option must be evaluated, considering the yield of the escrow securities and the effect of any inefficiency. Among the issues that should be considered with regard to each type of instrument are the following:

1. SLGS can be structured to comply with the federal tax law limits on investment return on escrow securities and eliminate any inefficiency in the escrow.
2. Open market securities may have a higher return but may not mature or pay interest on the date when debt payments are due. Issuers may be required to increase the issue size or blend higher- and lower-yielding securities to comply with yield-restriction requirements and generate sufficient revenues. Such inefficiency may be eliminated by future escrow substitutions. Additionally, forward supply agreements, guaranteed investment contracts, or float contracts also may be considered to minimize escrow inefficiencies. However, with these investment instruments, issuers need to be concerned with potential counterparty risk.

### **References**

- “Understanding Current and Advance Refundings,” *Government Finance Review*, April 1992.
- *Debt Issuance and Management: A Guide for Smaller Governments*, James C. Joseph, GFOA, 1994.
- Audio Cassette Tape, GFOA Annual Conference Session, “Advance Refunding: Tips & Traps,” 1996.

Approved by the GFOA’s Executive Board, 1995.