Refunding Bonds Terminology

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Supplement to GFOA Best Practice: *Refunding Municipal Bonds*

Listed below different terms and concepts that are important for issuers to understand in order to successfully execute a bond refunding.

Optional Redemption or Call Provision. Almost all bonds are structured with an optional call or redemption provision, which allows the issuer to prepay the bonds by redeeming them on or after a pre-determined date and at a pre-determined price (e.g. at par or 101% of par). It is the issuer's ability to prepay bonds prior to maturity that creates the opportunity to refund bonds in order to realize debt service savings. Bonds without an optional redemption provision cannot mathematically be refunded for savings. The optional call date has traditionally been about 10 years from the date of issuance of the bonds but, in recent years, issuers have increasingly issued bonds with earlier call dates.

Escrow Account. Advance refunding bonds and some current refunding bonds are structured to include an escrow defeasance account into which proceeds of the bonds are deposited and used to purchase investments that will pay the debt service on the refunded bonds up to and including the optional redemption date.

Escrow Securities or Defeasance Portfolio. The escrow securities or defeasance portfolio are those securities deposited to the escrow account and used to pay the refunded bonds up to and including the optional redemption date. The typical securities purchased for the escrow account are either State and Local Government Securities ("SLGs"), a type of U.S. Treasury security targeted to issuers of refunding bonds, or open-market U.S. Treasury obligations ("Open Markets"), typically Treasury bills, notes or bonds purchased by the issuer in the secondary market. Certain bond indentures may allow for other, typically higher yielding, government obligations to be included in the escrow account.

Savings Ratio. The savings ratio is one measure by which an issuer may elect to refund outstanding bonds. The savings ratio equals the total net present value savings of a refunding issue divided by the refunding bond proceeds (par amount of the refunding bonds plus original issue premium or less original issue discount). This formula may vary from between jurisdictions, primarily where the denominator is defined to be the par amount of the refunded bonds.

Refunding Efficiency. A measure of the projected or actual savings generated on a proposed advance refunding versus the total potential value of savings that can be generated in different market conditions. Refunding efficiency measures are often used by issuers and MA's to determine whether bonds should be refunded now or in the future in order to realize potentially greater savings. Refunding efficiency thresholds are often included in an issuer's formal debt or financial policies.

Legal vs. Economic Defeasance. A legal defeasance occurs when an escrow defeasance portfolio is funded with securities that are direct obligations of the U.S. Government and otherwise complies with the defeasance provisions included in the refunded bond indenture. An economic defeasance occurs when the escrow defeasance portfolio is funded with permitted investments that do not meet the defined criteria of a legal defeasance, such as Federal Agency securities ("Agencies") or other typically higher-yielding securities. In a legal defeasance, the refunded bonds are legally removed from the issuer's balance sheet and are no longer considered outstanding, while under an economic defeasance the refunding bonds may remain on the balance sheet.