Debt Refunding Guidelines

As rates have dropped, many bonds have been refunded. Issues sold in 2000 and 2001 have sometimes been advantageous to refinance. However, unlike home mortgages which media ads suggest should be refinanced every several months to take advantage of "lower rates," government debt can only be refinanced a limited number of times. When a refunding is considered, the limits need to be kept in mind to achieve reasonable results.

The major legal limit is that a tax exempt bond may usually only be refunded once in advance of the call date, or date for early redemption. This limit on advance refundings applies to nearly all governmental purpose debt outstanding. Since the non-callable period is usually 7 to 10 years, this limitation suggests a policy of not rushing into an early refunding for a relatively low savings level.

A second market limitation is the need to invest the refunding bond proceeds in U.S. Treasuries or Agencies until the early redemption date on the refunded bonds. During many years this was not a real limit, as the funds could be invested at a rate approximating what they were borrowed at. Currently, Treasury rates are so low that significant investment losses often occur in the escrow, known as negative arbitrage. This amount is reflected in the refunding computations of saving. It is legally possible by some units of government to invest in other types of securities to achieve slightly higher yields; this is currently not overly advantageous compared to the assumed risk.

While there is no magic formula on evaluating a refunding, two general guidelines are useful. The first is that the savings to the issuer should be at least 2% of the bond issue, on a net present value basis. Net means that all costs are already accounted for and present value equates each dollar to be received over time to the value of dollars today. Secondly, the governmental issuer should always receive more savings from a refunding than all of the fees paid.

These guidelines apply for advance refundings and current refundings, which are those at or after the call date. And, of course, exceptions occur. For instance, refunding $5,000,000 of debt at a cost of $75,000 with a 3%, or $150,000, present value savings is right in line. However, if the bond issue has only two years until it's retired, savings of perhaps $70,000 could be justified. In this case, $70,000 is better than nothing.

A final observation is that in most cases, only the callable portion of a bond issue should be refunded for savings. Administratively, this is more cumbersome but is it usually economically better.