Interest Rates

There is a lot of verbal speculation on long term interest rates – when will they actually increase and how much. We have no predictions.

However, it needs to be kept in mind that the Fed raising rates only affects short term rates. The Fed's effect on municipal rates is seen in the short term note and variable rate markets. Long term rates seem to be affected more by business cycles, inflation concerns and general economic growth perceptions.

The rate table on the cover demonstrates this lack of Fed impact on long term rates, or conversely how raising short term rates has perhaps helped dampen inflation fears allowing long rates to remain low.

Swaptions

A number of our clients have been offered swaptions and similar structures as a means of achieving refunding savings. Briefly, a swaption is a two part transaction: an option for a rate swap and the swap itself. To be beneficial, the outstanding debt needs to be of sufficient size and callable in a year or two. Often the debt is a refunding issue which can't be refunded prior to the call date or where there is such a loss in the refunding escrow because of low Treasury interest rates that a standard advance refunding doesn't work.

If a swaption is entered into, the issuer will usually receive an upfront payment for the option. Then the owner of the option will have the right to require the issuer in the future to sell variable rate debt and use the proceeds to call the outstanding fixed rate bonds. The issuer will swap the variable rate debt payments for fixed rate debt payments, equal to the original fixed rate bonds now refunded. The option holder will pay a variable rate payment periodically to the issuer, for payment of the variable rate debt.

The result of all of this is that the issuer gets an upfront payment and keeps making fixed rate payments as if the refunding didn't occur. The upfront payment is therefore the savings from the refunding. Additionally, the issuer is making payments on a variable rate issue while receiving matching payments from a third party.

Various considerations exist:

> The upfront payment may or may not be equivalent to what could be received if a standard refunding is accomplished at a later time. The value of the earlier payment is a judgment call, influenced by need and interest rate movement perceptions. Also, the earlier payment may often be used for non-debt purposes (project costs, teachers salaries, etc.,) while debt savings usually only affects a tax or utility rate.

Certain risks with the transaction exist:

> These may include a potential mismatch of variable payments in and out, the effect of a change in income tax rates and the financial strength of the third party's pledge to make payments to the issuer.

For further analysis, feel free to contact us.