

REFUNDING TIMING BIRD IN THE HAND OR TWO IN THE BUSH?



Timing on when to enter into a refunding transaction can be difficult. Significant savings may be available, but there is often the question of is it enough and could it get better by waiting. One factor is that in refinancing a bond issue, refunding bond proceeds must be invested in Treasuries until the call date on the refunded issue. This often leads to “losses” in the refunding escrow through very low interest rates on the Treasury securities. This loss is known commonly as “negative arbitrage” and is calculated as the difference between earnings at the rate on the new bonds and the actual investment rate received. Refunding transactions today with call dates in 2017-2019 may be very attractive due to historically low tax exempt rates, regardless of the amount of negative arbitrage.

Patience may be a virtue but the conundrum in waiting until closer to the call date and reducing the negative arbitrage is that the rate on the new bonds may rise, wiping out the added savings. Once a target for savings is achieved, it is difficult to wait to see if things get better. There is no “correct” answer.

As your municipal advisor, we routinely run refunding scenarios and valuations of refundings. Our goal is to keep our clients informed of the possibilities, so that clients can be aware of the savings levels and discuss savings targets. While no one can foresee the future of rates, having an informed discussion of risk and reward can aid in decision making.

ILLINOIS BUDGET IMPASSE AND THE EFFECT ON LOCAL GOVERNMENTS

The State of Illinois budget impasse has had an adverse effect on local governments within the State. Local governments are having trouble preparing their budgets because they rely on revenues such as sales taxes, state income taxes, motor fuel taxes and other state funding. Local governments have had to use reserves for day-to-day operations, find other means of funding, cut expenses or in some cases, cut services and programs provided to residents. In addition, there is uncertainty as to what local governments will receive or not receive from the state in the future.

The state recently approved a stopgap budget which will provide payments for the prior year and is good for the first six months of the current fiscal year. It is uncertain as to the priority, timing and the amount of payments local governments will receive for programs and services. The state continues to operate without the implementation of a full-year comprehensive budget.

Moody’s Investors Service has placed the general obligation bonds’ ratings of 19 Illinois community colleges on review for a possible downgrade. This is due to the state budget impasse and its effect on revenues of the community colleges. Illinois community colleges have not received any grant distributions or state aid in almost a year. Community colleges like other local governments are faced with increased financial risks and challenges, and the risk of future cuts in state aid distributions.

Moody’s Investors Service recently downgraded the credit rating of the State of Illinois from Baa1 to Baa2, two notches above non-investment grade. Standard and Poor’s and Fitch have also downgraded the credit rating of the state’s general obligation bonds with a negative outlook. Illinois issuers will continue to pay higher yields as a result of the financial condition of the state.