

# Refunded tax-free bonds



Wealth  
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When the general level of interest rates declines, a municipal issuer may find it advantageous to refinance or refund an existing bond issue. The process of refunding usually involves the selling of a new issue and then using the proceeds of that sale to meet the debt service requirements of the outstanding bond issue. In the case of an “advance refunding,” the proceeds from the refunding issue are typically invested (most often in U.S. government or federal agency securities). The cash flow from these investments is used to retire the outstanding bonds, often at the first optional call date. When a bond issue is within its call period, the proceeds from a “current refunding” issue can be used to retire bonds directly.

The refunded bonds then essentially become indirectly secured by U.S. government obligations, and their credit rating is based on the credit quality of the government securities rather than the credit quality of the original issuer.

In general, refunded and escrowed municipals represent safe, conservative investments for investors.

## Why are bonds refunded?

There are a number of reasons why an issuer of municipal bonds may elect to refund an outstanding issue of bonds. The most common reason involves interest cost. When interest rates decline, a refunding issue can be sold at lower cost, replacing

outstanding bonds sold at a higher interest rate. In some instances, even when interest rates have not fallen, an issuer may choose to refund an outstanding series of bonds. This type of refunding is known as a “low-to-high” refunding. In this transaction, a higher rate of interest is paid on the new bonds, but the amount of debt issued is lower. The main advantage here is that the issuer is able to reduce its debt burden and show improved debt ratios.

There are several other reasons to refund debt. One reason may be the issuer’s desire to remove a restrictive covenant existing from a previous issue. For example, an outstanding bond issue may place severe restrictions on a municipality’s ability to issue additional bonds. By refunding these bonds, the issuer is no longer encumbered by the restrictive covenant. Another common reason to refund an outstanding issue is to adjust the maturity schedule of bonded debt.

There are several different ways an issuer can elect to structure a refunding issue.

## Pre- and advance-refunded bonds

When interest rates decline, issuers of municipal debt may want to refund outstanding debt and take advantage of the ensuing interest cost savings. An issuer’s ability to retire outstanding debt, however, is often restricted by the presence of an

optional call provision. The optional call feature provides a period of time, typically 10 years, during which the issuer is unable to retire the bonds.

The solution to this problem involves a process called advance refunding or pre-refunding. The issuer uses the proceeds from a new sale of bonds (the “refunding” bonds) to purchase U.S. government securities. The amount of securities purchased provides sufficient cash flow to pay principal and interest on the old bonds (the “refunded” bonds) up to the first available call date. On the first call date, the original bond issue is then retired. The issuer is thus able to take advantage of the drop in interest rates while at the same time preserving investors’ rights to call protection.

An independent third-party trustee, who assumes responsibility for paying the bondholders, holds the government securities in escrow. In effect, holders of the original bond issue now possess an issue with a maturity equal to the first call date (or the date to which the bonds have been refunded). Additionally, as a result of the advance refunding, the quality of the old issue is substantially improved and takes on the quality of a U.S. government-guaranteed municipal bond. Essentially, the old bonds are now backed by U.S. Treasury or agency securities and, in most cases, are awarded a “AAA” rating by one or more of the rating agencies.

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## **Escrowed-to-Maturity (ETM) bonds**

This type of refunding is similar to advance refunding, except it provides a pool of securities designed to pay principal and interest on an outstanding issue all the way to its final maturity date. There is no acceleration of debt service, and the bonds continue to pay out interest to their stated maturity. The most common reason an issuer chooses to refund bonds by escrowing them to maturity, rather than advance refunding them to an optional call date, is the presence of a “non-callable” feature. Another reason to refund an issue by escrowing it to maturity is to eliminate restrictive covenants, such as those that would prevent additional debt issuance.

Over the past several years, some issuers have attempted to call bonds that had been escrowed-to-maturity. In these instances, lawsuits have typically been filed to try to block such an early call. Both the SEC and the MSRB have indicated that issuers defeasing bonds to maturity should clearly state, in both defeasance notices and in the official statement of the refunding issue, that they are reserving their call rights.

Assuming the pool of collateral is similar, there is no significant difference in terms of safety between an escrowed-to-maturity bond and a pre-refunded bond.

## **Crossover refunding**

As in other types of refundings, a crossover refunding involves the sale of new bonds and the purchase of Treasury or agency securities for the purpose of redeeming the old issue on a future call date. The essential difference is that in a crossover refunding, the stream of revenue pledged to secure the original issue remains in place and the cash flow from the Treasury collateral is used to pay interest on the new bonds. When the call date of the old issue arrives, the proceeds from the Treasury collateral are used to pay off the refunded bonds and the revenue stream that secured the old issue now crosses over to service the debt of the new refunding issue. The maturity schedule on the new refunding bond is structured so that there are no maturity dates scheduled until after the crossover/call date. Because of the crossover structure, there is no credit enhancement of either issue and, therefore, no potential for a rating increase on the bonds.

## **The collateral pool**

In the preceding discussion, we have referred to advance refunded or escrowed-to-maturity issues as being backed by U.S. government securities. Although Treasuries back a substantial majority of these issues, there are cases where the collateral pool is made up of U.S. government agency securities. In most instances the rating agencies do not differentiate between bonds

defeased by Treasuries and those by government agency securities (as long as they are not subject to an early call and are unconditionally backed by the full faith and credit pledge of the U.S. government)—both usually receive a “AAA” rating. However, in order to be certain of the exact status of the refunded issue, it is always prudent to examine the composition of the collateral pool.

There are some instances when the rating agencies choose not to assign a rating to the refunded or ETM bonds. Typically, this occurs when the issuer elects not to pay the rating agency a fee for a new rating. In this case, the bond’s rating remains unchanged even though the quality of the issue has improved significantly. In some cases, however, if the escrow structure does not meet the safety standards of the particular rating agency, the agency may elect either to award a lower rating or decline to assign a rating to the refunded bonds.

## **Summary**

When interest rates are at historically low levels, issuers of municipal securities often have the opportunity to refund old issues. The credit quality of refunded bonds generally improves to a “AAA” or an equivalent level while continuing to possess yields greater than other similarly rated issues. These investments are considered extremely safe and appropriate for conservative investors.