Municipal Bonds for America

Advance Refundings of Tax-Exempt Municipal Bonds

Background: A tax-exempt advance refunding bond can be used to refinance existing debt at more favorable terms, including lower interest rates. Generally speaking, an advance refunding is recommended when it can provide net present value savings of at least 3 percent of the amount of debt outstanding. Savings are often substantially higher than 3 percent. In the last five years, state and local governments have issued $392 billion in advance refunding bonds, generating – by the most conservative of estimates – at least $12 billion in savings.

By way of background, a bond is a debt instrument under which the bond holder receives periodic interest payments (coupons) and is repaid the bond principal on a specified date (maturity). If a bond includes a "call" provision, the issuer can redeem the bond prior to its maturity – generally, by paying the bond holder the face value of the bond, plus some added premium. Issuers generally "call" a bond to "refund" the debt at a lower interest rate.

- A refunding bond issued **within 90 days of redemption** of the "refunded" bond is a "current" refunding.
- A refunding bond issued **more than 90 days prior to redemption** is an "advance refunding."
- An advance refunding bond can be issued several years prior to redemption, but, more recently, most advance refundings have been issued within two years of redemption.
- Bond issuers may advance refund a bond only once.
- There is no similar limit on current refundings.

Refunding bond proceeds must be held in escrow until redemption, but earnings can be used to pay interest on the refunding bond until those proceeds are used to redeem the refunded bond. As a consequence, while both the refunding bond and refunded bond are outstanding, the issuer pays interest both on the refunding bond (albeit partly from earnings on refunding bond proceeds) and the refunded bond.

Again, as an industry practice, the net present value of an advance refunding generally exceeds at least 3 percent of the debt being redeemed. Higher savings are common. In fact, for periods where interest rates decline rapidly or during short periods of redemption and advance refunding can reduce the overall amount of interest paid.

Being able to issue a tax-exempt refunding outside the 90-day window for a current refunding gives issuers the greatest flexibility in taking advantage of lower interest rates and other market conditions, generating savings for the issuer, which are passed on to state and local residents.

Issue: The Tax Cuts and Jobs Act of 2017 proposes prohibiting the issuance of tax-exempt advance refunding bonds.

Provision: Strike the proposed repeal of advance refunding bonds.