



## ISSUE BRIEF (November 2012)

### Refinancing the State's General Obligation Bonds

The State of Minnesota issues municipal bonds to finance a variety of capital projects like state and university buildings and transportation infrastructure. The authority to issue these bonds is outlined in the Minnesota Constitution, Article XI, Section 5 and 7. Municipal bonds are typically structured to be repaid over a ten to twenty year timeframe. The Minnesota Constitution limits the repayment period on the state's general obligation bonds to no more than 20 years.

From time to time, municipal interest rates drop to a level where it may be advantageous to refinance the bonds and lock in lower interest rates, similar to the idea of a home mortgage refinancing. The process of refinancing the State's bonds is called a "refunding."

Municipal bond offerings often contain a "call feature" or optional redemption, which dictates which maturities may be refunded for savings and when they can be refunded and redeemed. Typically the maturities in the early years cannot be redeemed, while those after the call date can be redeemed, but not prior to the call date. Call features give purchasers a level of certainty in knowing exactly how much interest they will receive on their investment in the early years. A ten year call is typical for municipal bonds. A longer or shorter call period can impact the price the investor is willing to pay for the bonds. For example, if the call is less than ten years, the investor may bid higher interest rates in order to compensate for the fact that the bonds they hold may be called (and redeemed) earlier than a traditional ten year call period.

Per IRS regulation, tax exempt issuers (states, municipalities, public authorities, etc.) may refund their bonds prior to the call date *one* time during the life of the bonds by issuing advanced refunding bonds. The advantage to the issuer is that if the interest rate environment is much more favorable than when the bonds were originally issued, they are able to "lock in" interest rate savings early, instead of waiting until the call date. However, because issuers, including the State, are limited to one advance refunding, they often use defined refunding criteria (savings as a percentage of the refunding bonds, for example) in order to insure that they use their one time advanced refunding opportunity appropriately.

### Recent Refundings

The most recent traditional refunding conducted by the State of Minnesota occurred in September 2010. The State issued \$907.8 million in General Obligation Refunding Bonds (\$687.1 million Various Purpose Refunding Bonds and \$220.7 million Trunk Highway Refunding Bonds).

The \$687.1 million Various Purpose Refunding Bond sale resulted in a \$101 million onetime savings in debt service costs to the General Fund in FY 2011, but resulted in increased annual debt service costs in the out years because the bonds were issued with an original issue premium and under current law the State had to deposit that premium in the debt service fund and couldn't reduce the size of the refunding bonds (discussed below).

The \$220.7 million Trunk Highway Refunding bond sale resulted in a \$31.4 million onetime savings in debt service costs to the Trunk Highway Fund, but resulted in slightly increased annual debt service costs in the out years.<sup>1</sup>

In early FY 2013 (July 2012), the State issued \$21.9 million State of Minnesota Retirement System Building Refunding Bonds, Series 2012. Unlike General Obligation bonds, these bonds are secured by a dedicated revenue stream, in this case, pledged asset of the State's retirement system.

### **Premium Bids**

A common pricing strategy for bond investors over the last several years has been to offer "premium bids." The underwriter offers to purchase the bonds at higher interest rates (coupons) than the market might otherwise dictate but then makes a one-time payment at the time of sale, (original issue premium) to offset the higher interest rate. The underwriter does this in order to make the bonds more attractive to certain types of investors. Premium bids help ensure that the value of the bonds is retained or even enhanced by the investor if interest rates go up.

From the issuer's perspective, premium pricing can have distorting effects on overall debt service costs and the optimal issuance of bonds, particularly as it relates to refunding bonds. Until recently, Minnesota Statute 16A.641 subdivision 7 dictated that all refunding bond proceeds be deposited into the state bond (debt service) fund. (The effect of depositing a premium in the debt service fund was a one-time reduction in the general fund payment for debt service). The law did not account for the fact that investors are increasing bidding premiums, which has consequence of increasing debt service costs throughout the life of the bond issue. M.S. 16A.641 subdivision 7 was modified in 2011 to allow the proceeds of bonds to also be deposited in the bond proceeds fund where the size of the refunding bonds can be reduced to reflect the size of the bond issue, and as a result of a lower bond issue, the State can achieve lower debt service payment in future years.

### **Current Refunding Opportunities**

Minnesota Management and Budget (MMB) and the State's financial advisors monitor the interest rate market on a regular basis to see if there are opportunities to refund existing bonds.

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<sup>1</sup> When general obligation bonds are refunded, they do not reset to a new extended repayment period, but rather adhere to the original term of the existing bonds.

MMB reports that many of the good candidates for refunding (outstanding bonds with relatively high interest rates compared to current market conditions) were refunded in September 2010. In addition, because the shortest call date is currently October 1, 2015, any money raised in the refunding bonds will need to be held and invested in a yield restricted escrow account until the call date when the bonds will be redeemed. Due to low short-term investment rates, this renders some potential refundings less attractive due to what is called negative arbitrage. Negative arbitrage is a factor offsetting the current low interest rate environment for issuers, in this case the State to achieve its savings targets.

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