FREQUENTLY ASKED QUESTIONS:

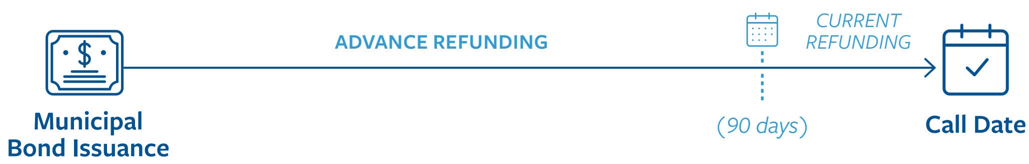
Advance Refunding of Municipal Bonds

1 | WHAT ARE ADVANCE REFUNDINGS?

State and local governments use the municipal bond market in order to borrow to finance capital improvements much like homeowners use mortgage loans to finance home purchases. Similar to homeowners, state and local governments **refinance their borrowings when interest rates fall** in order to reduce their debt service payments – which helps reduce their expenses.

By law, homeowners are able to pay off mortgage loans at any time with no penalty. In a mortgage refinancing, the proceeds of the new mortgage loan are applied immediately to retire the old loan, and the borrower is left with a lower interest payment on the new loan. In the municipal bond market, most borrowings may be retired no earlier than a predetermined optional redemption date (i.e. call date), typically 10 years following issuance. This call date for a bond issue is part of the bond documentation and agreed to by the buyers of the bonds. If a local government issuer completes a refinancing within 90-days of the call date, this is known as a **"current refunding"** and the refinancing bonds are generally able to retain the same tax-exempt status as the refinanced bonds.

But if the government issuer undertakes the refunding before the 90-day window, the refinancing is characterized as an **"advance refunding,"** which since January 2018 is not permitted under US tax law on a tax-exempt basis (even though the original bonds are tax-exempt).



Since January 2018, advance refundings are **not permitted on a tax-exempt basis** under U.S. tax law, even though the original bonds are tax-exempt.

2 | HOW DO ADVANCE REFUNDINGS WORK?

The Tax Cut and Jobs Act of 2017 prohibited tax-exempt advance refundings beginning in 2018. Before that time, tax-exempt advance refundings were common practice in the municipal market although each bond issue could be advance refunded only one time. When advance refunding was available, it allowed state and local government issuers to reduce their interest cost as rates decline. The interest on these advance refunding bonds was tax-exempt to the investors, allowing state and local governments to pay lower interest rates on their debt issuance.

In a typical pre-2018 advance refunding, a state or local governmental issuer sold tax-exempt refunding bonds in the public market at an interest rate lower than the original bonds that would be refinanced. The proceeds of the new bonds with reduced interest rates were deposited into an escrow fund, invested in US Treasury securities, and applied to pay debt service and the redemption price of the refinanced bonds through the call date. Upon financial close of the refinancing, the original or "refunded" bonds were considered to be legally defeased and the state or local government issuer is left servicing only the debt associated with the new refunding bonds. Interest and principal payments on these new, lower interest rate bonds were covered by whatever source of payment, e.g. taxes or toll road revenues, was originally pledged to the old bonds.

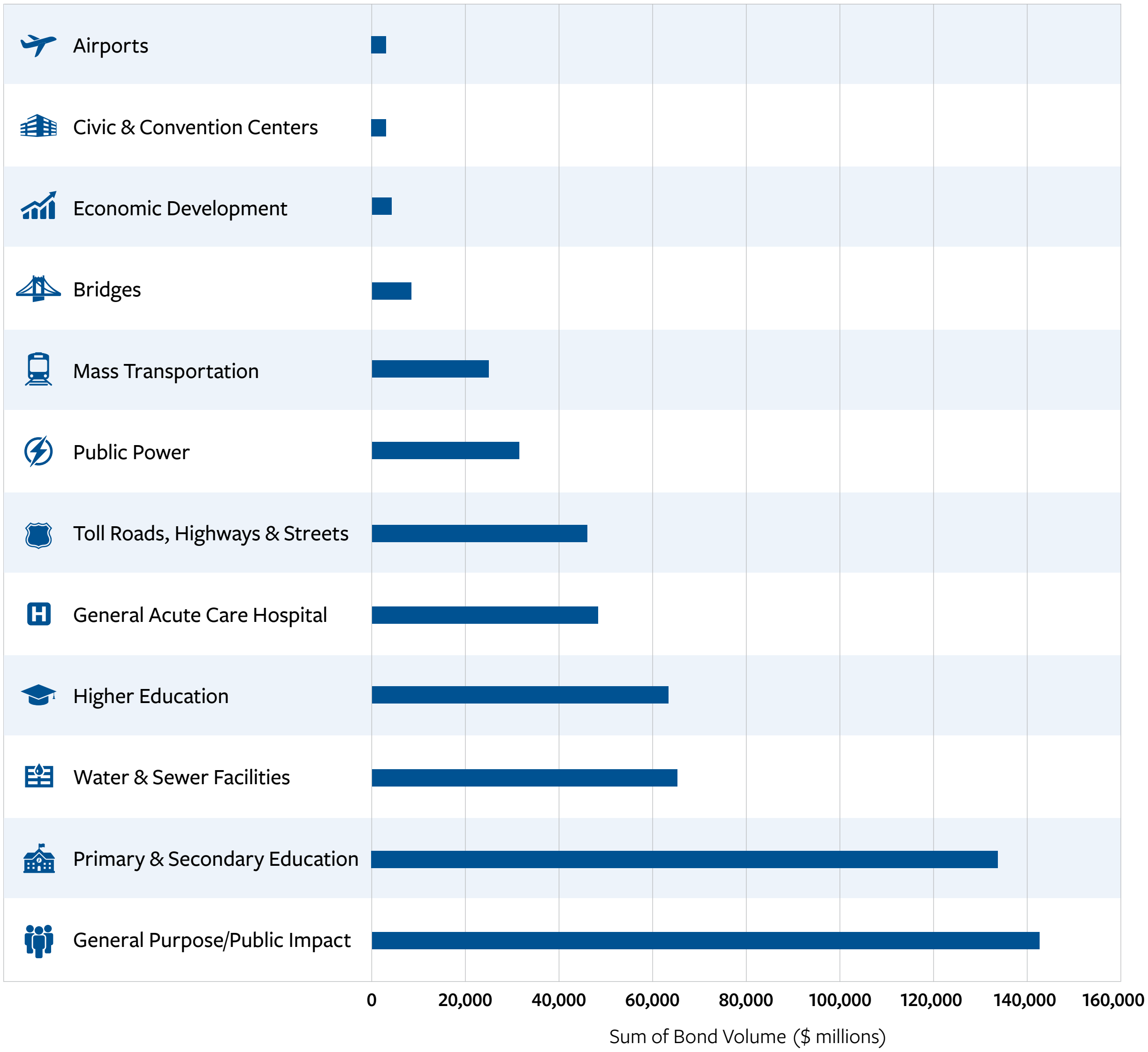
It is important to remember that an issuer was permitted to advance refund each new issue of bonds only once on a tax-exempt basis—state and local government issuers were judicious about when they used that one opportunity for an advance refunding. Most issuers set policies where they specified a minimum debt service or net present value of savings before they would undertake an advance refunding transaction.

> Before the Tax Cut and Jobs Act of 2017 took effect in 2018, an issuer was permitted to advance refund each new issue of bonds **only once on a tax-exempt basis**, so state and local governments were judicious about when they used that one opportunity for an advance refunding.

3 | HOW WAS ADVANCE REFUNDING USED PRIOR TO 2018?

All segments of the municipal bond market in rural and urban areas, including but not limited to: school districts, nonprofits, hospitals, higher education, transportation authorities, water and electric systems, airports and other core infrastructure providers used advance refunding as a tool to reduce interest costs. Despite the limitation to only advance refund bonds one time on a tax-exempt basis, state and local governments have generated **hundreds of billions of dollars of interest cost savings** over time. The savings derived from the advance refunding structure have directly funded infrastructure and governmental activities by reducing the interest payments state and local government issuers make to bond owners.

Advance Refundings – Top 12 Main Use of Proceeds (2007-2017)



GFOA ANALYSIS OF THOMPSON REUTERS DATA

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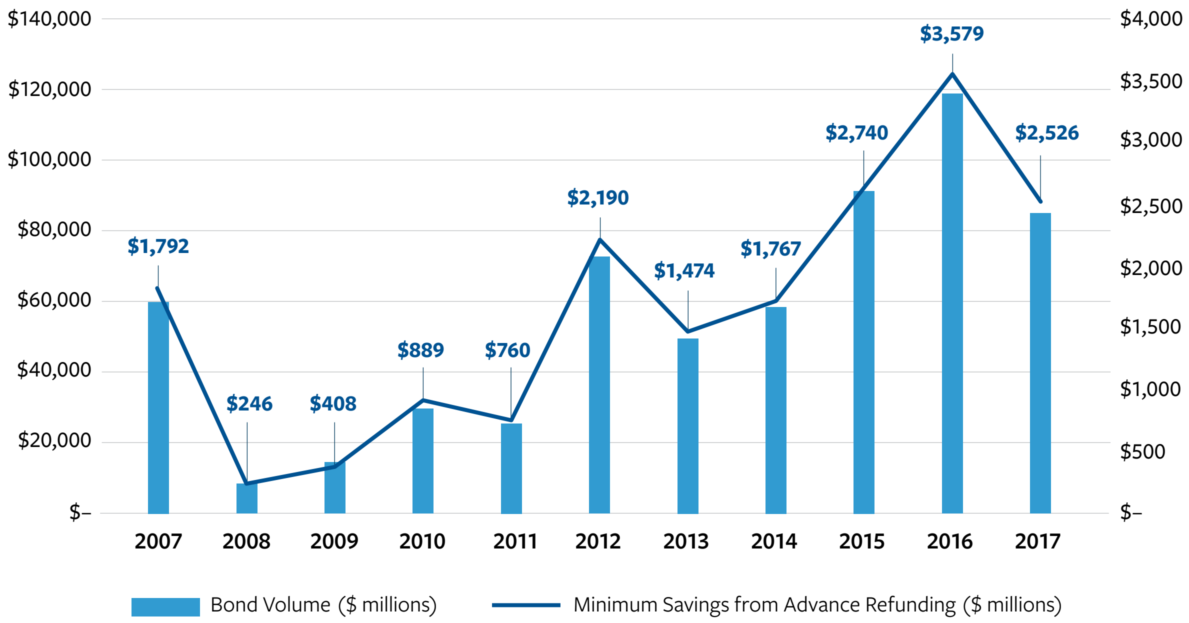
4 | DID ADVANCE REFUNDINGS GENERATE MUCH SAVINGS?

Advance Refunding Issuance



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According to the Government Finance Officers Association, between 2007 and 2017, there were over 12,000 tax-exempt advance refunding issuances nationwide which generated **over $18 billion in savings for tax and ratepayers over the ten-year period**. Moreover, advance refunding enables state and local governments to take advantage of low interest rates and lock in their savings even if the bonds to be refinanced are not immediately callable. If an issuer cannot advance refund bonds, it is at risk that interest rates will rise and the savings will disappear while it waits for the call date.

5 | WHY DOES THE FEDERAL GOVERNMENT CARE ABOUT ADVANCE REFUNDINGS?

The interest received by investors on most municipal bonds is exempt from federal income taxation. The federal government foregoes tax revenue on municipal bond interest as a way to **encourage and assist with capital investment** in infrastructure and similar capital projects and that allows state and local governments to issue bonds at a lower cost of capital. The tax-exempt status of municipal bonds dates back more than 100 years.

Because the federal government forgoes tax revenues on tax-exempt bonds, it has an interest in ensuring that tax-exempt bonds are used only for the purposes and by the guidelines permitted in tax law. Before the Tax Reform Act of 1986, state and local governments could issue an unlimited number of advance refunding bonds for any given issue. Some state and local governments undertook advance refundings even when interest rates dropped just a little and achieved minimal cost savings. There were some situations where there were three or four bond issues outstanding for a single project. Each of those issues generated tax-exempt interest for investors, and the federal government felt it was losing revenue on multiple bond issues.

Congress responded to this situation in the Tax Reform Act of 1986 by imposing a limit on advance refunding as well as establishing new anti-abuse rules and continuing to impose investment limitations and escrow yield restrictions. For bonds issued after 1986 and through 2017, state and local governments were permitted to **advance refund a tax-exempt bond issue just a single time** during its life. The arbitrage restrictions applicable after the Tax Reform Act of 1986 ensured that advance refundings were not being undertaken for investment purposes.

The single advance refunding limitation and yield restrictions were a practical solution to effectively limit transactions that were, at times, perceived as abusive behavior. This provided issuers an opportunity to advance refund bonds on a tax-exempt basis if the opportunity arose and ensured that there were never more than two bond issues outstanding for the same project. **This bipartisan solution**, which created a positive level of discipline for issuers as they knew they only had one chance to advance refund their tax-exempt bonds prior to the first optional call date, worked well for 30 years.

6 | WHY DID CONGRESS ELIMINATE ADVANCE REFUNDING IN 2017?

Congress gave little policy justification for repeal during the 2017 debate. In one document, proponents of repeal stated only that "The ability to issue advance refunding bonds allows state and local governments to issue and have outstanding two sets of Federally subsidized debt associated with the same activity."[1] Proponents failed to recognize that the then existing limitation of one advance refunding per issue and escrow yield restrictions was Congress' reform position that had already placed a significant limitation on these transactions. It was the 1986 solution to the perception of too many bond issues outstanding for a single project that stopped the previous abusive activities. The 2017 proponents of completely repealing tax-exempt advance refundings also failed to recognize the significant budgetary benefits that they convey to state and local governments. Further, it is likely that the provision was advanced primarily as a revenue offset.

[1] Committee on Ways and Means, US House of Representatives, *Report of the Committee on Ways and Means, House of Representatives, on H.R. 1 Together with Dissenting and Additional Views*, November 13, 2017, page 308.

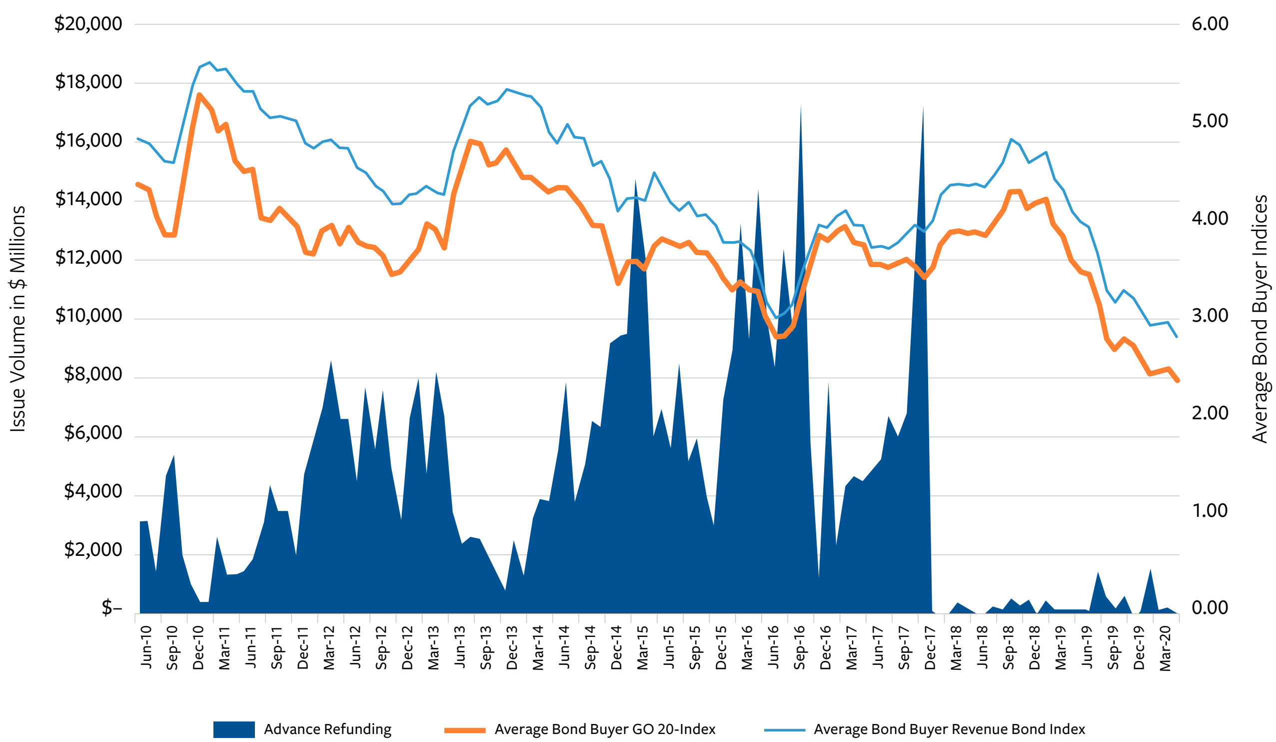
7 | WHY DON'T STATE AND LOCAL GOVERNMENTS EXECUTE ADVANCE REFUNDINGS USING TAXABLE BONDS?

Taxable bonds are generally issued at interest rates considerably higher than comparable tax-exempt bonds. Therefore, **on a taxable basis, there are fewer opportunities to economically advance refund tax-exempt bonds**. Even if a taxable refunding can produce savings, a tax-exempt refunding will almost always generate significantly more savings than a taxable advance refunding and will provide other advantages that are not present in the taxable market.

During the current period of historically low interest rates, some state and local governments have undertaken taxable advance refundings since tax-exempt advance refundings are prohibited. While those issuers were able to recognize some debt service savings for their transactions, the state and local governments, and ultimately their respective taxpayers and ratepayers, **are paying higher interest rates today** than they would be if tax-exempt advance refunding authority were still permitted by law.

In addition, the taxable bond market is oriented around corporate investment grade offerings which are large in size, with fewer and shorter maturities than the traditional municipal bond offering and no ability to call existing bonds at their face amount. The investor base for taxable municipal bonds is much smaller than the tax-exempt municipal market and is less accepting of the many small, long dated issues that comprise the vast majority of municipal bond offerings. As a result, many smaller government issuers have less access to the taxable municipal market which restricts their ability to issue taxable advance refunding bonds.

Advance Refundings Compared to Average Bond Buyer Indices *June 2010 – May 2020*



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8 | WHY DON'T STATE AND LOCAL GOVERNMENTS JUST USE CURRENT REFUNDINGS?

Current refundings, where the new, lower interest rate bonds are sold within 90 days of the call date for the old bonds, are the only tax-exempt refunding option available to states and localities under current law. **The problem with current refundings is their lack of flexibility on timing** since the market standard is for long-term municipal bonds to be non-callable for the first ten years. Thus, if the bonds to be refunded are not callable within 90 days, there is no ability to refinance those bonds on a tax-exempt basis. As a result, the issuer must delay the refinancing and there is no way to ensure savings with a current refunding since rates may rise while the issuer waits for the call date of the bonds to be refunded. Savings are only achieved if market interest rates are lower near the time that the original bonds are callable. For example, if a bond issue is callable in three years and in today's interest rate market significant savings could be achieved, the issuer is not allowed to take advantage of the low interest market. The issuer must wait the 3-year period to undertake a current refunding. However, interest rates in 3 years may not produce any savings at that point in time.

9 | WHO BENEFITS FROM TAX-EXEMPT ADVANCE REFUNDING?

State and local government issuers of municipal bonds **do not typically advance refund their debt unless there is a net present value of savings**. The savings on the amount of interest payments to investors benefits state and local government directly. These state and local governments can either use the savings to maintain state and local tax rate levels or reinvest those savings into additional infrastructure projects. Costs of issuance are a necessary but very small portion of the gross savings calculation, and are deducted when calculating if the present value of savings associated with a tax-exempt advanced refunding bond issue is enough to justify the refunding transaction. There are many states that as a matter of state law require minimum thresholds are met related to savings on refundings. In addition, most issuers have debt policies that establish minimum requirements as well.

10 | ARE INVESTORS HURT BY ADVANCE REFUNDINGS?

In an advance refunding, the investors in the original bonds typically see their investment **"upgraded" to the highest rating category** by the rating agencies, once an escrow fund is established to pay off the refunded bonds. These investors receive their principal and interest as those payments become due. At the stated call date, their bonds are paid off. Typically, investors then will need to reinvest their money in bonds that are now paying a lower interest rate. This is called interest rate risk or reinvestment risk for the investor.

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