LOCAL INFRASTRUCTURE ACT

Lifting Our Communities through Advance Liquidity for Infrastructure (LOCAL Infrastructure) Act
Senator Roger F. Wicker (R-MS) and Senator Debbie Stabenow (D-MI)

Frequently Asked Questions (FAQs)

1) ***What is an advance refunding?***

A refunding, also referred to as a refinancing, occurs when the proceeds of a bond are used to pay off another bond. To be considered an advance refunding (as opposed to a current refunding), the repayment of the outstanding bond must occur more than 90 days after the issuance of the refunding bond. Because the refunded bond cannot be paid off immediately under its terms, the proceeds of the new bond are used to purchase securities, typically state and local government series securities or U.S. Treasuries, which are put in a restricted escrow until the old bond is paid off.

2) ***Why do states and local issuers use advance refunding bonds?***

Most fixed state and local governmental debt may not be prepaid for ten years after issuance. That means that debt issued in and after 2011 cannot be currently refunded before 2021 or later. Advance refunding gives state and local governments the ability to access current interest rates for their refunding bonds rather than having to wait until they are within 90 days of the refunding date and potentially missing out on very low interest rates. This can save substantial interest cost over time. Additionally, recent instability in the financial markets highlight the importance of permitting issuers to have the flexibility to refinance in periods of favorable market conditions.The practice frees up capital for new and ongoing projects. Typically, these projects pertain to infrastructure, schools, hospitals, and airports, among other essential operations. (States and municipalities issued $475 billion in advance refunding bonds from 2012 to 2017, saving more than $14 billion of taxpayer money (FROM NACO).)

3) ***Because interest rates have fallen significantly, the spread between tax-exempt and taxable bonds has also been lowered. Is there still a large demand for advance refunding?***

Most fixed state and local governmental debt may not be prepaid for ten years after issuance. Given the current financial crisis, state and local governments are looking for ways to restructure outstanding debt and reduce current interest payments. Because advance refunding may not currently be done on a tax-exempt basis, many issuers are advance refunding those outstanding bonds on a taxable basis in order to respond to cash flow issues. While the current taxable rates are relatively low, taxable bonds continue to be more expensive than tax-exempt bonds and the ability to advance refund those earlier bonds on a tax exempt basis would result in additional savings and free up additional needed current capital. In addition, taxable bonds are often structured with make-whole call provisions that restrict future refunding flexibility.

4) ***What has the impact of repealing advance refunding been on the muni market?***

The repeal of tax-exempt advance refunding reduced refinancing options for state and local governments and often required more expensive taxable advance refunding in order to restructure outstanding bonds.

5) ***Do cities and municipalities currently have access to financial management tools to refinance their outstanding debt? Do these methods have additional risk or additional cost compared to advance refunding bonds?***

Many alternatives to tax-exempt advance refunding have arisen but in most cases, the alternatives are more expensive or have additional risk. These alternatives include, among others, (i) taxable advance refunding, (ii) entering into a forward starting interest rate swap to lock in current rates, and (iii) issuing "forward delivery" bonds that are sold at current rates (plus some premium to account for the delivery delay) but delivered within 90 days of the refunding date.

<u>Items (i) and (iii) above are simply more expensive than tax-exempt advance refunding. Item (ii) comes with additional risk that burned many municipalities in the 2008/2009 financial crisis and has left many municipalities unwilling to bear that risk again.</u>

6) ***What is the distributional impact of advance refunding?***

The savings realized from advance refundings can be used by states and local governemnets for additional infrastructure projects or to keep state and local tax rates level during this time when state and local government finances are constrained due to the COVID-19 pandemic.

7) ***What guardrails are in place to prevent abuses of the tool?***

Tax-exempt bonds have been in the tax code since 1913. Prior to TCJA, tax-exempt advance refundings of tax exempt bonds were permitted with certain restrictions and these restrictions would be continued with the reinstatement of advance refunding. Private activity bonds other than qualified 501(c)(3) bonds cannot be advance refunded on a tax exempt basis. In most cases, a bond issue can only be advance refunded once with tax-exempt bonds~~,~~ -exempt bonds that are advance refunded with tax-exempt bonds are required to be redeemed on the first permitted optional call date. Issuers are required to restrict the yield on investments held in the advance refunding escrow to-not more than one one-thousandth percent above the yield on the refunding bonds.

8) ***Is the service cost for financial advising to refinance a bond expensive for a local government?***

Although sometimes bonds are refunded to address restrictive terms or covenants, state and local govenments typically require a certain percentage of savings be achieved to enter into an advance refunding transaction, inclusive of costs.

Contact: Tara McGee (Tara_McGee@Wicker.Senate.Gov) or Neal McMillin (Neal_McMillin@Wicker.Senate.Gov)