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Taming Premium Bonds

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What sort of bonds should a municipality offer to the market? A generation ago, simple par bonds were the answer. Today, callable premium bonds are extremely popular, though they also impose burdens on both issuers and to the market in general. While there is something wild about these bonds, fortunately there may be a way to tame them.

Callable premium bonds now dominate the new issue markets. Coupons are set as high as 5% against much lower market yields. The bonds sell at a premium because they pay more interest than the market requires for a par bond. But will the high interest payments stop on the call date (price-to-call), or continue to maturity (price-to-maturity)? Fortunately for premium bond buyers, the price-to-worst rule means that they typically pay only the price-to-call, often much lower than the price-to-maturity.

The call option takes on a different character when it applies to a premium bond instead of a par bond. In either case, there is the ``time value" of a possible, but not guaranteed, decline in future rates. However, options on premium bonds also have "intrinsic value" built into them from the outset. Callable premium bonds become immediate candidates for excellent savings from an advance refunding, or at least they would be, if not for negative arbitrage on escrow securities. Although immediate refunding after issuance is impractical, premium callable bonds are likely to be advance refunded well ahead of their call date to lock in savings.

Callable premium bonds are popular. The professionals involved in issuing bonds enjoy two rounds of fees. The high coupon protects investors against the danger that the price could fall through the "de minimis" threshold for market discount tax treatment. A callable bond can be an attractive (and higher yielding) substitute for a noncallable bond that matures on the callable bond's call date. Savvy investors also expect a ratings upgrade from the eventual backing of a Treasury escrow.

The Case Against Callable Premium Bonds

When an issuer sells a callable premium bond, it receives the price-to-call instead of the higher price-to-maturity. The difference between these prices constitutes "lost proceeds" – the issuer cannot spend this value on a project. It is instead stored as intrinsic value in the call option. The call option can be liquidated later with a refunding for "savings" even if interest rates never drop.

While it is certainly pleasant to find savings, illusory savings do not serve an issuer's constituents. The callable premium bonds make it virtually certain that the issuer will pay issuance expenses twice.

Certainty in the long-term funding costs for long-term assets is important for some issuers. Par bonds provide that certainty, while callable premium bonds place only a loose cap on costs. The ultimate debt service is only known when the bonds are refunded.

Callable premium bonds may have helped to drive out individual investors, who now comprise only a tiny part of the market. The bonds make it harder for investors to evaluate the fairness of quotes from their brokers. It no longer suffices to compare similar bonds of similar maturities. Benchmark yields near the call date can be more relevant to fair pricing than those near the stated maturity date. And it does not help that redemption information is often buried in the back pages of documents or on the secondary screens of electronic systems.

If callable premium bonds are driving out individual investors, support for the tax exemption could erode.

There may be regulatory risks. Given their fiduciary responsibility, municipal advisors should take care that a structure that practically requires the issuer to double their issuance costs is truly in their clients' best interest. Regulators might also question whether these bonds confuse investors or inflate the supply of outstanding tax-exempt bonds.

In summary, the problems with callable premium bonds include that they:

- lead issuers to incur additional issuance costs;
- distort the meaning of refunding savings;
- deprive issuers of committed long-term funding at current market rates;
- may be driving individuals out of the market, thereby weakening support for the federal tax exemption;
- are making the market more opaque and less liquid; and
- may draw increased regulatory scrutiny.

A Solution

One way to mitigate the side effects of callable premium bonds is for issuers to diminish the importance of the options. For traditional par bonds, call options had time value – they were used only if interest rates fell, or if the issuer needed to restructure – but they had no intrinsic value at the time of issuance. Though options were important to bond pricing, they did not cause wild adjustments to prices.

Issuers can continue to sell callable premium bonds to meet the demand for premium bonds (to reduce the chance of triggering the market discount rule), while also preserving the traditional structural benefits of the call option. Rather than bury the intrinsic value in an option, only to extract it through a later refunding, the issuer can take the intrinsic value as immediate proceeds.

The key is to change the par call prices to premium calls in a way that equates the price-to-call and the price-to-maturity. This is possible because the price-to-call includes the present value of any call premium. To find a "breakeven" call price, set the premium on each call date to the amortized premium (as if the bond runs to maturity). This new call price matches the price-to-maturity at the original yield, with the call date replacing the settlement date.

Now return to the issuance date. The price to the premium call matches the price-to-maturity. The price-to-worst rule has no effect if all call prices are set to their breakeven levels (the chart shows how the call prices will decline toward par for longer call dates). Now the issuer is fully paid for its entire debt service schedule.

A premium bond with a par call has complex dynamics, like the motion of a hinged pendulum. A premium bond with a premium call can behave more simply, like a par bond with par call.

Where premium bonds with par calls are intermediate-term bonds disguised as long-term bonds, premium bonds with premium calls are true long-term debt. In today's low rate environment, issuers would be wise to secure true long-term funding.

Premium bonds with breakeven premium calls offer the following benefits to the issuer:

- The issuer is fully compensated if the bonds run to maturity.
- The issuer obtains long-term committed funding at the current market rate.
- The issuer only pays to refinance the bonds if interest rates fall or there is a structural need.
- The issuer’s bonds will be easier for investors to value and understand, leading to better liquidity and pricing for issuers.
- High coupons continue to shield investors from market discount treatment.

Of course, there are always potential downsides and unintended consequences to new methods. One of these is that the market may not welcome bonds with large call premiums. As a first step, issuers could set call prices that begin at a modest premium and then decline to par.

Industry groups and leading issuers should consider this proposal. With time, premium call prices could become an accepted way to make premium bonds behave more like par bonds and to bring some clarity to the market.

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