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MUNICIPAL COMMENT

JANNEY INSTITUTIONAL MUNICIPAL STRATEGY

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Tax Reform's Cost to Municipal Issuers

With the passage of the Tax Cuts and Jobs Act, issuers of tax-exempt debt no longer have the authority to advance refund bonds with tax exempt debt after December 31, 2017. The new law amends Section 149(d) of the U.S. tax code, repealing advance refunding issuances so that a tax exempt bond cannot be issued to refund another bond more than 90 days before the redemption date. Advance refundings permitted issuers to lock in lower interest rates or sometimes change legal provisions or restructure debt, while still honoring the call protection on the outstanding bonds. The law eliminates an important financing tool that states, municipalities, and other 501(c)3 nonprofits have utilized to lower borrowing costs or modify debt structures prior to the call date. Interest on current refunding bonds remains tax-exempt. Advance refundings comprised about 13% of total municipal issuance through the end of November before the rush to market in December. The percentage of advanced refundings edged up to 15% at year end, according to Bloomberg Intelligence.

The justification used to validate the repeal of advance refunding bonds is that it "unfairly" provides governmental and qualified 501(c)(3) borrowers the ability to issue two sets of "federally subsidized" debt to finance the same activity. Lobbying groups, to no avail, advocated to preserve the ability for tax exempt issuers to advance refund bonds or at least delay the implementation date because of the compressed time period from the release of House's bill (H.R. 1) in early November. Many issuers accelerated financing plans by year end over the uncertainty of what provisions would ultimately be included in the final legislation, leading to record-breaking issuance volume. December issuance was $62.5 billion according to the Bond Buyer, beating the prior record of $54.7 billion in December of 1985.

Potential Options to Replace Advance Refundings

The complete elimination of advance refundings, which also includes crossover refundings, begs the question of what alternative options will be available to municipal borrowers. A variety of products are likely to emerge. Identifying and evaluating refunding options is complex, requiring careful analysis specific to a borrower's unique circumstances to weigh the benefits and costs appropriately. Taxable debt can be used to refund a bond prior to the redemption date, though this will unlikely produce economic savings and would more likely be used to restructure debt. For new money issuances, shortening the call protection to an earlier date rather than what has become the typical ten-year call is an avenue for exploration. However, structuring debt with an earlier call date will likely result in somewhat higher interest costs at the time of issuance, depending on market conditions.

A Pivot Back to Variable Rate Debt and Swaps?

Under the right interest rate and credit market environments, turning to variable rate debt and interest rate derivatives to reduce interest costs on current or future transactions could be a viable option. Although, variable rate debt and swaps add new risks to a debt portfolio compared with fixed-rate financings, requiring careful analysis and understanding of a more complex capital structure. Since the 2008-2009 financial crisis, public finance borrowers have reduced their exposure to variable rate debt and swaps due in part to the unmasking of the risks, as well as the low interest rate environment.

Historically, municipal borrowers entered into fixed payer swaps to hedge interest rate risk on variable rate debt, but there are other less commonly used derivative products. Fixed to floating rate swaps, forward starting swaps, and swaptions could be proposed as financing options. The ability to understand and manage the impact of the various risks, such as amortization, basis, collateral posting, counterparty, credit, liquidity, tax, and termination risks is important in the event that the swaps do not perform as intended. Issuers lacking ample reserves or budget flexibility to absorb adverse events should be explored carefully as the interest rate savings may not be worth the risk of a more exotic debt profile.

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Recent Challenges to the Tax Exempt Sector

The Tax Reform Act of 1986 was the last time Congress made major changes to the tax code that impacted tax-exempt issuers, including the addition of certain limitations on the volume and frequency of advance refunding transactions. Bonds issued prior to 1986 could be advance refunded twice. In the more than 30 years subsequent to 1986, there has been periodic pressure on curtailing various aspects of the tax exempt arena. While the proposed elimination of private activity bonds (PABs) in the House's version was absent from the signed bill, there are reports of other potential bills that may aim to set limitations around PABs. While the relatively slow rate of significant legislative change on tax-exempts is apparent, using history as a basis for predicting the future has its risks. Given the current political environment, it is plausible that some tax exempt issuers, such as hospitals or higher education will be under heightened scrutiny to justify their tax exempt status. On the other hand, the current "win" could quiet legislative agendas around these topics in the near term as public finance issuers and the market digest the changes.

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