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Refunding by Rule-of-Thumb: A County Finance Fable

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By Andrew Kalotay

Randall Saggs 3d, managing director of Ferris & Lardner, gave a little self-satisfied snap on his suspenders after he put down his laser pointer. For the past 15 minutes Saggs and his team of bankers had mesmerized the eight-person Rhineburg County Council. Never mind that none of them fully understood the subject; Saggs' arguments and the dollar signs were compelling.

The topic: a $50 million 5%, 25-year general obligation bond callable in 10 years, underwritten by Ferris barely three years ago. The annual payments on the issue constituted 30% of the budget. Would the savings justify doing another deal?

Interest rates had dropped about a third of a percent since the bonds came out, and Saggs was back at them again to refund at a cheaper rate. The crux of his argument was that the 3.2% present-value savings had exceeded the county's 3% threshold for refunding.

On the face of it, the deal made sense. It offered a net present-value savings of $1.6 million for a rural county of 20,000 inhabitants, about $80 per citizen.

Greta Van Dorn, a 70-year-old pensioner and councilwoman, neatly dressed in a gray sweater and tortoiseshell horn-rimmed glasses, kept squinting at the sheet of paper in front of her.

She was busy celebrating her golden years by never minding whom she irritated, and clearly the slickness of the bankers' presentation irritated her. It was so persuasive, offering almost no alternative but to come to the desired conclusion.

"Very true Mr. Saggs. Your numbers do point toward substantial savings," she said, staring at the paper. "But what are we giving up?"

"Great question Greta, I couldn't have put it better myself," jabbed an encouraging Bob Abernathy, Rhineburg County accountant, as if to cheer her on.

Through the whole presentation Abernathy had sat listening, chair tilted back against the wall, yet looking like some big cat ready to pounce. Greta's remark brought him forward with a thud.

"What Randall isn't really emphasizing is that we're giving up the right to refund that same issue at a future date," he said. "Financiers call it forfeited option value. That has to be weighed against the total interest savings we're required to consider. It's the one extra step in the process of analyzing a refunding that I heard at a presentation recently."

Abernathy went on to explain how at last June's Government Financial Officers Association conference in Fort Lauderdale one presenter had questioned this very same 3% convention, as well as some others, warning against imposing hard and fast percentages in guidelines and rulemaking.

The presenter questioned why half of the total bonds issued in the muni world had 5% coupons, considerably higher than prevailing rates, and why almost every long-maturity bond was callable in 10 years. Many of these conventions stand, he argued, to benefit the underwriter more than the county issuers. Bonds issued at abovemarket rates are more likely to be called or advance refunded, generating more transaction fees for underwriters.

Now that he was being seriously challenged, Saggs went on the offensive, adopting a condescending but conciliatory tone toward Abernathy, while addressing the bulk of his remarks to Councilwoman Van Dorn.

“We read about what he said. It is pure theory, just like evolution,” Saggs said. “It’s certainly elegant, but not yet endorsed by any of the oversight authorities. You need not pay attention to his arguments.”

For dramatic effect, he stood up, clasping his thumbs over his suspenders, to deliver the coup de grace.

“You should, however, follow the GFOA guidelines, which say that you should refund when savings reach 3%,” he said. 'It’s the county’s policy.”

This guy clearly irritated Greta Van Dorn.

“But since when did they outlaw common sense?” she asked. “Why follow every letter of the guidelines if they don’t lead to the best solution every time?”

“Right again, Greta,” said Abernathy. “Give me until the next meeting and I’ll come up with an analysis calculating the various costs and savings and lost option value and see if it makes sense to do this deal.”

Next week they met again. Saggs and his team were in attendance, and Abernathy took center stage. Here’s what he found.

Ferris & Lardner’s so-called deal wasn’t as great it sounded. Indeed, there was $3.2 million in savings prompted by lower interest rates. But the trade-off was poor. Abernathy found that the county would give up $4.6 million in option value in doing the deal.

In terms of efficiency, the savings returned only 70% of the $4.6 million option value. A great deal for Ferris & Lardner. But definitely not a good deal for the county, in Abernathy’s books.

What’s more, Abernathy’s young staffers pointed out that the county has been paying dearly in extra interest cost for the 10-year call option on this $50 million issue — an estimated $150,000 (30 basis points) annually.

“When we issued these bonds three years ago, we made a bet that interest rates would go down,” Abernathy said. “And now we’re winning that bet. Why on earth would we give away a chunk of our winnings? It’s like trading a full house for three of a kind and not getting paid for it.”

So Abernathy and Van Dorn voted against the deal. The rest of the council voted for, and the deal went through, six to two. The refunding was done a month later, giving Ferris an estimated $500,000 in underwriting fees, not to mention the turn on any subsequent trades.

The truth was the $1.4 million difference wasn’t enough to turn the tide. It would have to be substantial indeed to break the chain of friendship so common in state politics. Ferris was a well-known pal of Mayor Oscar Finebone and a major campaign contributor around Rhineburg.

“Well, that’s great,” said Greta, who felt that she and Abernathy had done the right thing, only to have it thrown back in their faces. They commiserated on the way out to the parking lot after the council meeting.

“But think of the money that’s being squandered year-in, year-out by doing these refundings,” she said. “If the local newspaper ever bothers learning arithmetic and adds up just how much is been squandered, there’ll be the devil to pay.”

Replied Abernathy, as he opened the door of his Volvo and brushed off the snow: “Don’t worry Greta, the devil takes his off the top.”

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