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Mass. Hardens Refunding Guidelines

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by: Paul Burton

Massachusetts has adopted more rigorous guidelines for bond refundings that state officials say will enable them to better gauge opportunities for such deals.

“We’ve been working on this for more than a year,” said Colin MacNaught, the assistant treasurer for debt management. “We have more than 30 banks covering the Commonwealth of Massachusetts, each one with their own approach to methodology and presentation, which is anything but consistent. How do you compare inconsistent presentations efficiently?”

The new guidelines, which Massachusetts issued this week, are available on the state’s investor website, http://massbondholder.com, and the Municipal Securities Rulemaking Board’s EMMA website.

Massachusetts, which has conducted few refundings the last few years, is considering one.

In the past, state officials based refunding decisions solely on a present value, or PV, cash-flow savings threshold test. In the future, in addition to PV savings, the state will also consider the forfeited option value of the refunded bonds. When the refunding bonds are also callable, their option value should also be incorporated, the guidelines say.

Massachusetts said it will base its decision on whether the projected PV savings are enough when compared with the net loss-of-option value. The treasurer’s office will consider refunding proposals only if the efficiency of the transaction exceeds 85%.

Andrew Kalotay Associates Inc. of New York helped Massachusetts craft the guidelines.

“You need some standard way and that’s what Colin is trying to do,” the company’s founder and president Andrew Kalotay said in an interview. “Standards should be there all the time, not some crude rule of thumb.”

For example, according to Kalotay, many municipal bond issuers will act when a 3% threshold is reached.
“Taking into account the forfeited option value is a more rigorous way to look at refundings,” MacNaught said. “It captures what you might be giving up, and it’s a way to capture the probability that rates could go lower. We’re creating a finer prism through which to consider a refunding.”

The Kalotay report acknowledges that some may question the recommended volatility of 15%. “Option value, which increases with volatility, forms the denominator in the refunding efficiency ratio,” the report says. “Thus, too high a volatility overstates the efficiency, which in turn triggers fewer refundings. Conversely, too low a volatility overstates the efficiency, which results in refunding too early.”

John Hallacy, head of municipal research for Bank of America Merrill Lynch, doesn’t think the stringent guidelines will trigger investor pushback.

“It’s a worthy goal to standardize things, to put everybody on a level playing field,” he said. “The question is, does it have any effect on creativity? Will it allow for creativity, for trying something different?”

MacNaught doesn’t think the new guidelines will have a stifling effect.

“I’m all for ‘creative’ ideas. But creative refunding proposals not done accurately are of no value to us,” he said. “More important than creativity is consistency and accuracy, and these guidelines hit both of these points.”

Fitch Ratings and Standard & Poor’s rate Massachusetts general obligation bonds AA-plus, while Moody’s Investors Service assigns an Aa1 rating.

“I’m not sure that investors are concerned about it, but I myself as an analyst always have concerns,” added Richard Larkin, a senior vice president and director of credit analysis at Herbert J. Sims & Co.

Larkin recalled New York City’s use of refundings during budget struggles in the early 1990s, with the city only 15 years removed from its major financial crisis.

The city at the time used present-value savings to justify refunding that merely pushed current budgeted debt service out as long as 20 to 30 years, under the PV savings rubric, “which I thought was pure bull,” Larkin said.

“New York under [Mayor David] Dinkins made a lot of budget assumptions and would do a refunding that they justified on present value savings. They thought they were being smart. But it added up the cost of debt over 20 years and in many cases it was higher.”

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