THE BOND BUYER

You haven't heard of ratchet bonds?

By
Andrew Kalotay, *President, Andrew Kalotay Associates Inc.*
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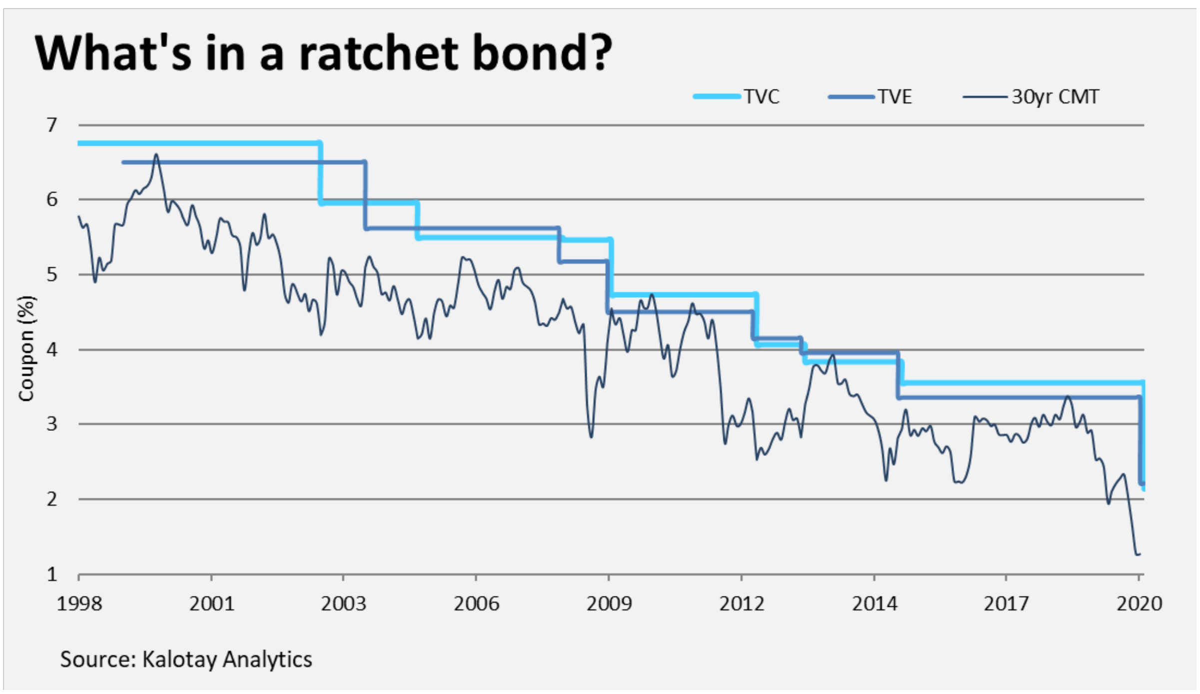
Managing callable bonds is a challenge for issuers. There is much wringing of hands as to when to refund. Damned if you do and then rates decline, and damned if you don't and rates rise. But don't worry, you're certain to be wrong — the probability of refunding at the perfect time is zero. And then there are the transaction costs. In the lifecycle of funding and refunding transactions associated with a project, these costs can add up to several points.

What if there was a debt structure that essentially "refunded" on autopilot, and without transaction cost? Well, the ratchet bond does exactly that.

The Tennessee Valley Authority, at our advice, issued two of these structures in the late 1990s — the 6.75s due 2028 (NYSE: TVC) and the 6.50s due 2029 (NYSE: TVE). Both issues were oversubscribed, and raised over $1 billion in proceeds for TVA. These bonds are floaters with a twist. After an initial lockout period of five years, their coupons are reset every year to the 30-year Constant Maturity Treasury (CMT) plus a fixed spread, but *only if such a reset would lower the coupon*. Earlier this year, the coupons for TVC and TVE were lowered from 3.550% and 3.360% to 2.134% and 2.216% respectively, more than 400 basis points below their initial levels.



The current coronavirus crisis has been devastating to the finances of state and local issuers. The resulting shock to credit rating, whether actual or perceived, creates significant refunding risk. The ratchet bond would protect the municipality from such risk, because it remains outstanding until maturity.

Why would a ratchet bond, which resets only in the wrong direction, appeal to investors? When a callable bond is redeemed, the holder likely reinvests in a similar credit at lower yields. With a ratchet bond, the investor is automatically in that state without the transaction cost of reinvesting.

The default risk of a ratchet bond is the same as that of a like maturity bullet bond. The ratchet structure could contain a put at par that is contingent on a coupon reset. This feature gives investors the right to redeem the bonds if they don't like the new coupon relative to yields of comparable credits. By adding this feature, TVA saved a few basis points.

If you're an issuer, consider ratchet bonds — the best debt structure you've never heard of. They eliminate inefficiencies and transaction costs associated with calling and refunding. They also protect from credit events that could hamper refunding. Why not ask your bankers to send you a ratchet bond proposal the next time you want to come to the market?