Debt refinancing diminishes but can still be the right play

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"Reverse scoop and chuck." Sounds like a fancy backhoe maneuver on a construction project. Or maybe the latest passing play in the Browns' playbook (like Red Right 88, only different). But it's actually a refinancing strategy that I became familiar with while a school board member at **Rocky River City**. The strategy saved taxpayers hundreds of thousands of dollars and accomplished other significant objectives.

Most refinancings of outstanding school district debt and lease obligations are designed simply to save money. It's like refinancing a home mortgage. If interest rates go down, there are interest cost savings to be had by entering into a new deal, assuming a school district can exit the old deal without too much financial damage in terms of prepayment penalties and transaction costs.

Most school districts refinance debt to save money. The logic is the same as refinancing a home. If interest rates go down, entering into a new deal can reduce costs.

Even if interest rates stay relatively flat, school districts can potentially save money. That's because their longer bond maturities, originally issued with relatively high interest rates, become, with the simple passage of time, shorter bond maturities that can be refinanced at relatively low interest rates.

Sometimes refinancings can result in savings not by replacing higher interest rates with lower interest rates across the board but by shortening the repayment period — like converting a 30-year mortgage to a 25-year mortgage. Of course, all other things being equal, shortening the repayment period means increasing the annual debt service payments. But, in cases where assessed valuation is increasing, annual debt service might be increased without millage impact to taxpayers while saving a significant amount of interest costs. The **Beachwood City** School District is perhaps the grandmaster of accomplishing taxpayer savings by shortening the repayment period.

Where do the savings go? Well, if a school district is refinancing voter-approved bonds issued for a major building project, the savings go to the taxpayers, who pay less money. Each taxpayer might not save a significant amount of money in any given year, so communications to constituents about savings need to be framed appropriately. But pennies make dollars, and taxpayers in the aggregate can save an eye-popping amount of money over time. Potentially millions of dollars can stay right at home, which is good stewardship of public funds.

Other long-term obligations are not repaid from voter-approved tax revenue deposited directly into a bond retirement fund. These include lease-purchase obligations, which often are in the form of certificates of participation (COPs) in a lease revenue stream. When those obligations are refinanced for interest cost savings, the savings benefit the fund or funds out of which debt service is being paid — typically a permanent improvement fund or the general fund. So, more money ends up in the school district's bank account to build and maintain facilities or fund educational programs.

Sometimes, a refinancing is not required to obtain interest cost savings. School districts from **Poland Local (Mahoning)** to **Strongsville City** have simply taken existing money that was earning interest at relatively low rates and applied it to an early payoff of existing debt that was bearing interest at relatively high rates.

Refinancings of school district obligations for interest cost savings became more difficult after the enactment of the federal Tax Cuts and Jobs Act, effective Jan. 1 of this year. School district obligations are typically issued as federally tax-exempt obligations, which enjoy lower interest rates than their federally taxable counterparts, benefitting school districts and their taxpayers. Federally tax-exempt refinancing, or "refunding," obligations, in turn, come in two varieties: "advance refundings" and "current refundings." Advance refundings occur when the new obligations are issued more than 90 days prior to the early redemption date, or call date, of the existing obligations. Current refundings occur within that 90-day period. Under the Tax Cuts and Jobs Act, advance refundings are now prohibited.

The result of the ill-advised prohibition against advance refundings is that school districts now have less flexibility to capture the financial benefits of a low interest rate environment. School districts now generally need to wait at least until 90 days prior to the call date to refinance their existing debt and lease obligations on a federally tax-exempt basis. By that time, interest rates may be higher, and a refinancing might not make economic sense.

Depending on the circumstances, refunding tax-exempt bonds with taxable bonds could still be beneficial if the yield curves for tax-exempt and taxable obligations are compressed, as **Chagrin Falls EV** discovered. And, the market for school district securities is starting to absorb changes to account for the new federal prohibition. For instance, some securities are being issued with shorter call periods, which is the time between the issuance of obligations and the first date they can be redeemed. That enables school districts to not wait as long to refinance existing obligations on a tax-exempt basis. **Willoughby-Eastlake City**, for example, just issued COPs with a five-year call period, down from what typically was eight to 10 years.

While less frequent, a school board also can decide to refinance existing obligations to meet other goals beyond interest cost savings. This brings me back to the aforementioned "reverse scoop and chuck." That Rocky River City refinancing, accomplished under the expert supervision of Treasurer **Greg Markus**, reduced interest costs significantly by taking advantage of lower interest rates and repaying the principal sooner. In other words, it "scooped" the principal and "chucked" it toward earlier years, which is the "reverse" of what is perhaps more common in the municipal securities market. In addition, the transaction restructured existing debt service to build a modest millage cliff — a fall off of expected millage in a specific year to coincide in time with the expected next request for new tax revenue from the voters. This can serve to blunt the impact of new millage and thus make the ballot request more palatable to voters.

I have seen and participated in school district refinancings designed chiefly to accomplish other objectives as well. These include, for example, issuing refunding securities in order to exit the federal Build America Bonds program when the federal government began cutting the associated interest rate subsidy due to budget sequestration.

Whether refinancing makes sense for a particular school district involves application of discount rates to provide a present-value understanding of the transaction; assessed-value predictions; assumptions about interest rates based upon an understanding of the market for school district securities; and other factors. Thus, school districts considering a refinancing will frequently engage the services of those who specialize in giving this kind of financial advice to school systems.

Whether for savings to taxpayers, increases in revenue to the permanent improvement or general fund, restructuring debt service to accomplish election-related or other objectives, or other reasons, it is a good idea to keep school district refinancings on the radar screen. Refundings were sucker-punched by the Tax Cuts and Jobs Act, just like the Browns were sucker-punched by owner **Art Modell** in 1995 when he announced he was moving the team to Baltimore (as represented famously on the cover of Sports Illustrated in December of that year).

But each will endure, although refundings will likely recover better than the Browns. It's impossible to recover much worse. ■

About the author: Cleveland-based **Rick Manoloff** is a partner at the Squire Patton Boggs (US) LLP law firm. He has decades of legal experience representing Ohio school districts on financing matters and has contributed to Thomson Reuters' Ohio School Law book as a co-author. He recently served on the Rocky River City Board of Education and was chair of its Finance Committee. He also was part of the legal team that fought to keep the Browns in Cleveland.