William Blair

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Muni Market Notes

Premium Bonds: A Short-Term Trend or the New Normal?

Historically, individual investors have eschewed paying higher premiums in exchange for higher coupon payments on bonds. In today's rapidly changing interest rate environment, however, this paradigm is shifting as investors are increasingly willing to pay premiums at $1.20 or higher in favor of 5% coupon bonds rather than paying $1.05 for 3% coupon bonds.

This shift has been occurring for the last six months as investors realized we are at the bottom of the interest-rate cycle, and the shift is accelerating. Since the beginning of January, approximately one-third of municipal bonds issued in Connecticut had coupons of 4% or greater; only 10% of the bonds during the final three months of 2012 had coupons of 4% or greater. Investors want to be in a position to liquidate their bonds, if necessary, once interest rates begin to rise, and the belief is that higher coupons will be easier to sell in a volatile market.

The recent shift toward premium bonds is actually helping issuers. The net effect of this change does not change the amount of debt service that issuers pay. When a higher premium is received for selling bonds, the amount of bonds needed to be issued will be less. Issuers should not be afraid to see higher-coupon bonds in their upcoming proposals and sales; it is a chance to earn a little more for every dollar borrowed.

Impact of Rising Interest Rates on Premium Bonds

Bond	Coupon	Maturity	Yield to Maturity	Price
A	4.00%	10 years	3.00%	108.584
B	5.00%	10 years	3.00%	117.168

If market rates were to rise by 100 basis points (1.00%) immediately...

Bond	Coupon	Maturity	Yield to Maturity	Price	% Price Change
A	4.00%	10 years	4.00%	100.000	-7.91%
B	5.00%	10 years	4.00%	108.175	-7.68%

This hypothetical example is for illustrative purposes only. The value of an investment in debt securities will fluctuate in response to market movements. When interest rates rise, the prices of debt securities are likely to decline, and when rates fall, prices tend to rise.

How Negative Arbitrage Destroys Refunding Savings

In the most common method of refunding outstanding bonds, refunding bond proceeds are used to purchase government securities for an escrow account to pay the principal and remaining interest on the bonds being refunded. Negative arbitrage occurs when the yield on those government securities is below the yield on the refunding bonds. When there is negative arbitrage, the result is a greater issue size and less refunding savings; this often undermines the feasibility of the advance refunding.

For example, assume a refunding bond issue has a yield of 3.0%. Although the issuer is eligible to earn up to 3.0% in the refunding escrow, due to market conditions, the escrow is invested in eligible securities that produce a yield of only 1.0%. The difference between the yield of the refunding bonds (3.0%) and the yield of the refunding escrow (1.0%) is negative arbitrage. As a result of negative arbitrage in this hypothetical example, the issuer would need to increase the amount of refunding bonds it issued, potentially eliminating all or a substantial portion of refunding savings brought about by a drop in interest rates.

William Blair Welcomes Lorrie DuPont

We are pleased to announce that Lorrie A. DuPont recently joined William Blair's Public Finance Group to lead the team that serves higher education and nonprofit institutions. Ms. DuPont has more than 30 years of experience working on traditional debt, lease, and structured financings for higher education academic medical centers, cultural institutions, and other not-for-profit organizations, including such major universities as the University of Chicago, Duke University, and the University of Michigan. The projects she has financed include a broad range of administrative, academic, healthcare, athletic, and research facilities as well as student services facilities.

Effects of Sequestration on Build America Bonds (BABs)

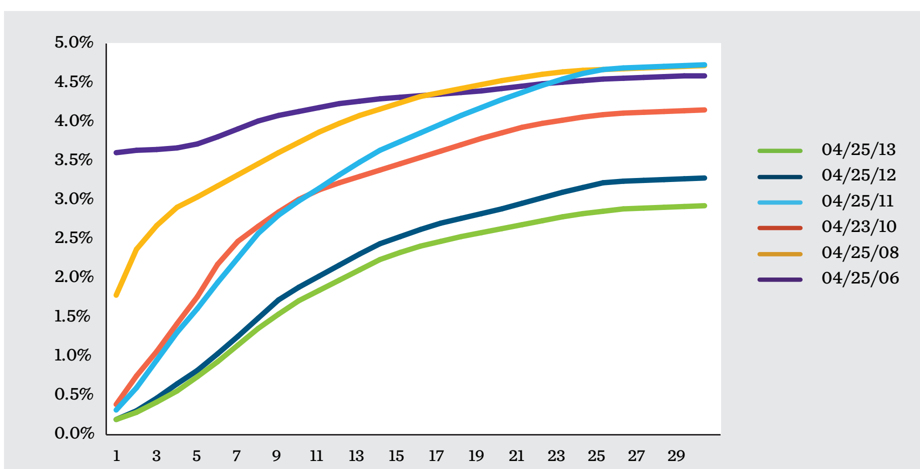
The reality of federal sequestration has made it clear that issuers cannot be assured that they will receive their subsidy checks throughout the terms of their BABs; this creates a real risk for both issuers and bondholders. According to the IRS, the sequester reduction is applied to Section 6431 amounts claimed by an issuer on any Form 8038-CP filed with the IRS that results in a payment to such issuer on or after March 1, 2013. The sequestration reduction rate will be applied until the end of the fiscal year (September 30, 2013) or until Congress intervenes.

These reductions apply to Build America Bonds, Qualified School Construction Bonds, Qualified Zone Academy Bonds, New Clean Renewable Energy Bonds, and Qualified Energy Conservation Bonds for which the issuer elected to receive a direct credit subsidy pursuant to Section 6431. As determined by the Office of Management and Budget, payments to issuers from the budget accounts associated with these qualified bonds are subject to a reduction of 8.7% of the amount budgeted for such payments.

Issuers should complete Form 8038-CP in accordance with the form's instructions. Affected issuers will be notified that a portion of their requested payment was subject to the sequester reduction. Issuers should use this correspondence to identify the portion(s) of amounts requested that were subject to the sequester reduction.

Municipal Yield Curve Comparison

AAA MMD curves - 2006-2013



Note: Reflects market conditions as of April 25, 2013
Source: Thomson Financial

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