PMA™ SECURITIES

UNDERSTANDING MUNICIPAL BONDS

Forward Settlement Current Refundings

JULY 2022

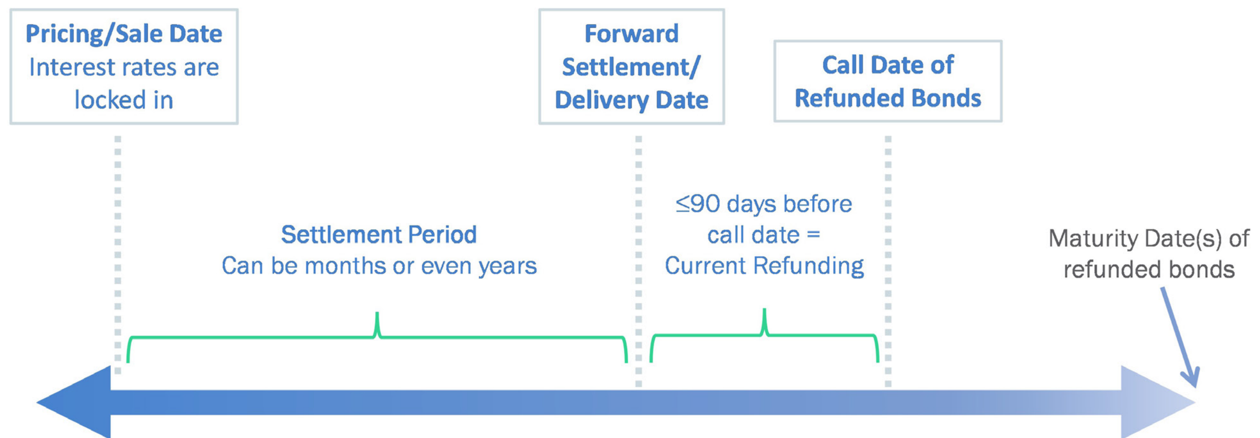
When the Tax Cuts and Jobs Act was signed into law in December 2017, issuers lost the ability to sell tax-exempt advance refunding bonds. Among several available alternatives, forward settlement bonds can uniquely allow issuers to not only take advantage of current interest rates, but also benefit from tax-exemption.

REFUNDING BASICS

The call date is the first date on which the Issuer can pay off or refund its bond issue prior to maturity. A refunding bond issue that closes 91 or more days before the call date is defined as an advance refunding. At this time, the U.S. tax code does not allow for tax-exempt advance refundings; therefore, advance refunding bonds must be issued on a taxable basis for which investors typically expect higher interest rates. On the other hand, a refunding bond issue closing within 90 days of a call date is considered a current refunding and may be issued on a tax-exempt basis.

FORWARD SETTLEMENT CURRENT REFUNDING

The settlement period between the pricing or sale of a municipal bond issue and the closing date (i.e. settlement or delivery date) is typically within one month. With a forward settlement, delivery could be months, or even years after the sale, allowing the issuer to lock in current market rates for a transaction that will not close within the typical time frame. By selecting a future closing date within 90 days of the call date, the forward settlement refunding bonds are considered a current refunding, eligible for tax-exemption.



In exchange for holding the rate on the bonds for a longer time, the investor typically charges a yield premium due to the illiquidity of its investment during the settlement period. The yield premium, if any, is determined by the investor and can vary depending on the length of time until the forward delivery date. Even with a yield premium, a forward settlement current refunding may provide a more favorable outcome than a taxable advance refunding, depending upon market conditions. This approach enables an issuer to lock in savings on a tax-exempt current refunding before reaching the current call window, which is especially attractive in a rising interest rate environment, particularly if the yield curve is relatively “flat.”

SPECIAL CONSIDERATIONS

Forward settlement bonds often require two closings: one shortly after the sale date (a "soft closing") and another on the future delivery date. The firm that purchases the issuer's bonds may require a dual closing approach to confirm that the legal conditions are met when the bonds are first sold, and then to confirm there has been no change in law or other facts since the sale that would inhibit successful delivery of the bonds.

Additionally, with a forward settling bank placement, the issuer may be required to execute a rate lock agreement – essentially a hedging agreement that protects the bank in the event the bonds are not issued (i.e. closed) on the expected forward delivery date. If interest rates are lower at that time than the present, the issuer would need to make a payment to the bank. Conversely, if interest rates are higher at that time, no payment would be required. The issuer and its counsel should carefully review the terms of any proposed rate lock agreement.

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