

Considerations When an Issuer Decides to Issue and Purchase Its Own Bonds

Whether they are providing education, well-paved streets, or anything in between and beyond, units of local government have a specified purpose to provide for the public good. As public entities, local governments are not typically seen as sophisticated financial institutions that participate in complex financial instruments. But the reality is that local governments can, and do, engage in both financial borrowings and investments far more involved than one might expect. Because of this, any activity outside of standard borrowing and investment practices should only be considered with the utmost caution and a thorough understanding of these proposed ideas.

One such practice in the local Illinois market is the act of a government entity purchasing debt that the entity itself has issued. At first thought, it may seem there is a good reason for a local government to employ this strategy.

First, a unit of government purchasing its own bonds would be done as a direct placement and would avoid the burdensome process of accessing the capital market in a public offering. A public offering is accompanied with higher issuance costs and stricter disclosure requirements. Also, a direct placement may not require ongoing disclosure requirements that increase the number of administrative tasks imposed on the local government. Additionally, any type of direct placement should be completed with much lower issuance costs since rating and underwriting fees are eliminated, and legal and advisory fees are typically lowered. *However, the issuer only benefits from the elimination of these services in a direct placement if the advisor does not charge an above market fee, capturing some or all of the incremental benefit.* Also, it may be appealing to local officials that the unit of government can set the interest rate on the bonds since it is seemingly acting as both issuer and purchaser of the same financing transaction. In fact, these officials may interpret this flexibility as a means to lower the borrowing cost and save its taxpayers money in the form of lower debt service payments.

However, marrying the two practices of borrowing and investing in the same transaction has several pitfalls, and should only occur after the governmental entity has undergone a thorough review of the strategy. The balance of this memo describes the factors that need to be considered when a unit of government is considering the purchase of its own bonds.

1. Tax Status of Bonds to be Issued and Purchased:

When a local government issues and purchases its own bonds, the federal government requires that the bonds be issued on a taxable basis. Conversely, municipal bonds can typically be issued on a tax-exempt basis, providing a lower borrowing

cost to the issuer. The tax-exempt feature is essentially a subsidy provided by the Internal Revenue Service (IRS) to local units of government. When the bonds are issued on a taxable basis, the local government is foregoing the available subsidy provided by the IRS and paying a higher borrowing cost than it otherwise would.

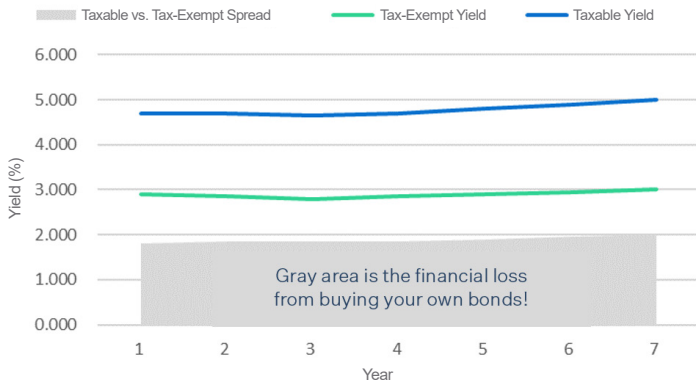
It may be argued that borrowing at the higher taxable rate is not necessary when the local government acts as both issuer and investor. After all, the public entity can assign whatever interest rate it would like since the entity is acting in both capacities. However, there are two reasons why this is not a viable argument. First, bond counsel will require that the finance professionals guiding the issuer through the process must certify that the interest rate reflects a rate supported by the current market environment. Second, even if a lower interest rate is used to resemble a tax-exempt interest rate, then the local government is not earning as high a return on the investment as it otherwise would. This is because units of government are not subject to federal income tax, and therefore, can purchase higher-yielding taxable securities without paying any federal or state income tax. Because of this advantage afforded to units of local government, when they do invest in other municipal bonds, it is almost always an investment in taxable municipal bonds.

Therefore, regardless of the interest rate used on the bonds, the local government fails to take advantage of its status as a tax-exempt entity when it purchases the very bonds it has issued. Fundamentally, this is akin to a homeowner not taking advantage of the specific federal tax deductions available to an individual as a homeowner. Nobody would do so willingly.

2. Taxable and Tax-Exempt Interest Rate Difference:

Given that the local government is giving up one of the inherent advantages afforded to it from the IRS, the logical ensuing question should ask: "How significant is this advantage?" The answer to this question is that it depends on the spread between taxable and tax-exempt interest rates. If, for example, the spread is zero, then the local government does not sacrifice anything when it purchases its own bonds. However, the larger the spread becomes, the greater the cost that the local government is incurring by pursuing a strategy of purchasing its own bonds. *In the current market environment, this spread ranges from 1.80% to 2.00% over the 7-year term of a "AA" rated Illinois General Obligation credit as shown on the following page. For every million dollars borrowed, assuming a seven-year term, the financial loss from a local government buying its own bonds is \$78,250. The current spread is vastly greater than the spread from the same time period in 2021 when it ranged from 0.18% to 0.42%.*

Current Taxable vs. Tax-Exempt Yields for “AA” Rated IL Issuer



It’s worth noting that this factor becomes increasingly important as one also considers the shape of the yield curve. Throughout most periods of interest rate history, the spread between taxable and tax-exempt interest rates is smaller on the short end of the yield curve and becomes increasingly larger on the long end of the yield curve. So typically, if a governmental entity is considering purchasing the bonds that it issues, economically this strategy may make sense if the final maturity of the bonds is relatively short (i.e., in the range of 1-3 years), where the spread between taxable and tax-exempt interest rates is notably less significant. This is not entirely true in the current interest rate environment, where the spread is approximately the same in year 1 as it is in year 7, as shown above. Having noted this, the following paragraph provides a reason against even purchasing bonds with a short final maturity, especially under current conditions.

3. Liquidity of the Bonds:

For most local governments, the investment in municipal bonds is considered a buy-and-hold investment and is made using funds that are not needed for immediate liquidity. Moneys that do require a higher degree of liquidity would most likely be invested in a money market fund or more liquid financial instruments, like certificates of deposit.

Therefore, if the local government has the financial flexibility to invest with a longer duration, it would be advisable to purchase taxable investments that have a longer final maturity, not short municipal bonds that provide incrementally less return than longer dated bonds, particularly in a steep yield curve environment. In addition, the issuer would be subject to market risk. If interest rates are sufficiently higher at the time of liquidation than they were when the bonds were originally issued, the local government may have to sell the re-issued bonds at a price that is lower than the price at which the original bonds were purchased.

The market risk, if realized, would create incremental financial burden on the issuer that would not have been incurred had the issuer pursued a more traditional strategy of originally selling the bonds in the capital market.

4. Public Perception:

When a unit of government buys its own bonds, it does not receive an infusion of capital, yet it is committing taxpayers to payments of principal and interest over time. The public may ask, if you have the funds to buy your own bonds, then why not use those funds to pay for the project directly instead of taxing for more funds? One may even say that the issuer has not invested or borrowed but created a levy to generate an additional revenue stream.

Conclusion: While the temptation to implement this strategy may be appealing, there is much to be considered when an issuer is purchasing its own bonds. It may seem like a sophisticated approach to lower or control borrowing costs.

However, in most cases, it is safe to say that this strategy either increases borrowing costs or reduces investment return, neither of which constitutes an advisable financial management approach. If finance professionals are attempting to sell this option to your government, please contact a PMA municipal advisor before making any decisions. We would be happy to review this and other alternatives for you and your unit of government.

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