

# Tax-Exempt Tender Transactions: Discussant Perspective

---

BROOKINGS

**2024 Municipal Finance Conference**

July 17-18, 2024

**Allen W. Garman**

***Maryland Transportation Authority***

# Issuer Perspective

- Response to paper from an issuer perspective.
- Concept of refinancing when rates have risen is surprising and counterintuitive.
- Reminiscent of Advance Refundings that were critically characterized as:

*Accepting small cash flow savings today in lieu of much larger probable savings in the future.*

- Reviewed 75 maturities provided as part of a tender refinancing proposal.

Trying to predict the future is like trying to drive down a country road at night with no lights while looking out the back window.

- Peter F. Drucker

My advice to the unborn is, don't be born with a gambling instinct unless you have a good sense of probabilities.

- Jack Dreyfus

## Now or Later?

- A bird in hand is worth two in the bush.
  - Misuse and misapplication of proverb.
- Rather than considering guaranteed savings now versus uncertain savings in the future, consider the call option value (Falcon or *bird in hand*) as having higher probable future value (cash flow savings) relative to the smaller near-term savings of a tender refinancing.
- Critically important to consider the call option value in terms of future cash flow savings.

# Behavioral Finance – Rules of Thumb

- Human decision processes contain traits that bias our thought process away from a purely rational approach.
- Decision makers gravitate toward heuristics or rules of thumb to make decisions rather than a strict rigid rule of optimization.
- Arbitrary Heuristics or Rules of Thumb
  - 3-5% NPV Savings
  - A bird in hand is worth two in the bush.
- Alternative Consideration
  - Call Option Retained may be worth more than current savings.

# Categorizations

Category	Market Price	Refunded Bonds From	Refunding Bonds To	Notes
1	Small Premium/Discount	Optionless	Optionless	Buy at market yield, reissue at same yield, no possible savings. (Ignore coupons and transaction costs.)
2	Small Premium/Discount	Callable	Optionless	Savings similar to call date, small decline in rates favors waiting. Illusion of savings derived from conversion to optionless. Why not issue noncallable at time of issue? Breakeven rate declines were low, averaging 8 bp.
3	Small Premium/Discount	Callable	Optionless	Savings much lower than projected call date savings. Even if interest rates rise significantly, still better off waiting. Breakeven rate increases were large, averaging 40 bp.
4	Small Premium/Discount	Callable	Callable	Exchange of short call for longer call, lower coupon for higher coupon. Savings greater at the call date, even when considering a subsequent refinancing. Breakeven rate increases were large, averaging 77 bp.
5	Deep Discount	Callable	Callable	Exchange of short call for longer call, lower coupon for higher coupon. Low coupons of 2-2.5%, subject to Market Discount taxation. Bonds priced at deep discount distortion due to Market Discount taxation. Buy bond at high gross yield, reissue at lower tax-exempt yield.

# Observations and Questions

- Many tender candidates appear suboptimal when considering future cash flow savings at the call date.
- Illusion of savings when exchanging callable bond for optionless bond.
- Call option values should be considered.
- For bonds trading at deep discounts and subject to Market Discount taxation, could the economics of buying back via tender at a high gross yield / low price and reissuing at the lower tax-exempt yield and high coupon, warrant an analysis utilizing Refunding Efficiency?
  - Does the market pricing distortion with deep discount coupons and associated Market Discount taxation create a favorable opportunity for issuers?
- Why is the industry failing to consider call option value for the majority of the tender refinancings with near par or premium structures?