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The benefits of the sub-prime loan mortgage crisis . . .

Is now a good time to refinance debt?

On Tuesday, January 22, 2008 the Federal Reserve Bank lowered the fed funds rate three-quarters of point to 3.50%. The interest rate on fed fund account balances is closely monitored to gauge the Fed's view on the economy. The accounts are held by member banks and are usually used for lending or borrowing from one another. The fed funds rate is regarded as a key indicator of all U.S. domestic interest rates. By reducing the fed funds rate, the Federal Reserve is hoping to stimulate business activity by reducing the cost of lending to commercial borrowers. The reduction in the fed funds rate was precipitated by a significant decline in the world equity markets.


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The Dow Jones Industrial Average (DJIA) opened the same morning down 450 points, but ended the trading day down only 128 points. The next day the DJIA opened down 300 points, but then ended up about 300 points. Maybe this action by the Federal Reserve will stabilize the markets; but maybe it won't.

The DJIA consists of 30 of the largest and most widely held public companies in the United States. It reflects the relative market value of the stocks included in the average. It is one of the three most widely observed indexes in the U.S.

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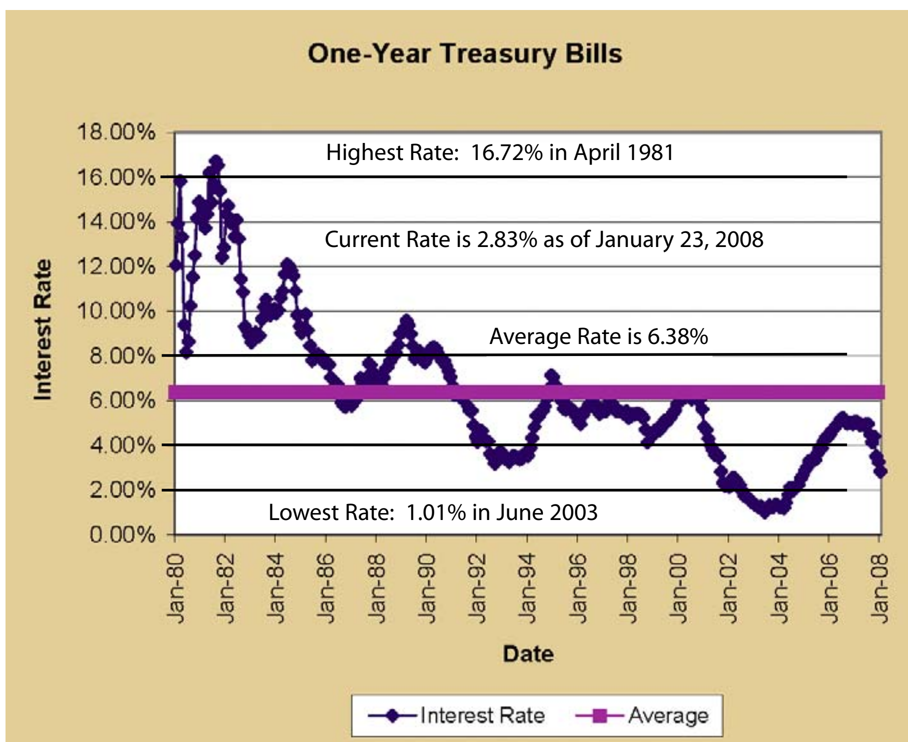
The other two most significant indices are the Standard and Poor's 500 Index (S&P 500) and the NASDAQ Composite Index. The DJIA is a very narrow index since it only follows 30 of the highest capitalized corporations. The S&P 500 is a wider index than the DJIA since it follows 500 of the leading companies in various major industries. The NASDAQ Composite Index is a much wider index than the other two indices. It includes more than 3,000 companies listed on the NASDAQ Stock Market. Many of the smaller capitalized companies are traded on the NASDAQ Stock Market (but it does include large companies such as Microsoft).

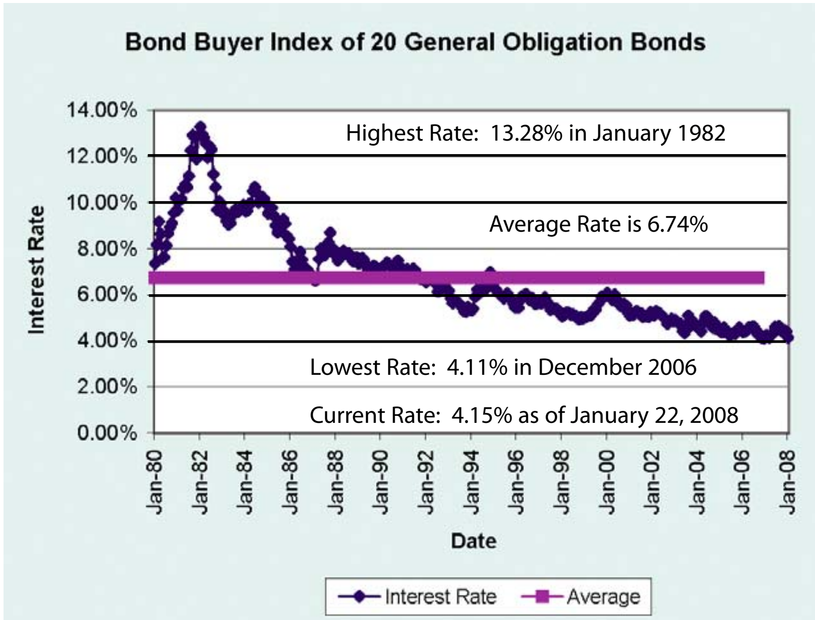
These indices are utilized by various professionals in the field of finance to measure the relative economic health of corporations



specifically and the economic vitality of the U.S. in general. Many of the world markets (as measured by their own indices) were off by almost 10% between January 21 and 22 depending on the time zone. The Federal Reserve reduced the fed funds rate to demonstrate to the markets it was going to do what is within its purview to head off the same type of sell-off in the U.S. in the short term and prevent the economy from falling into a recession for the long term.

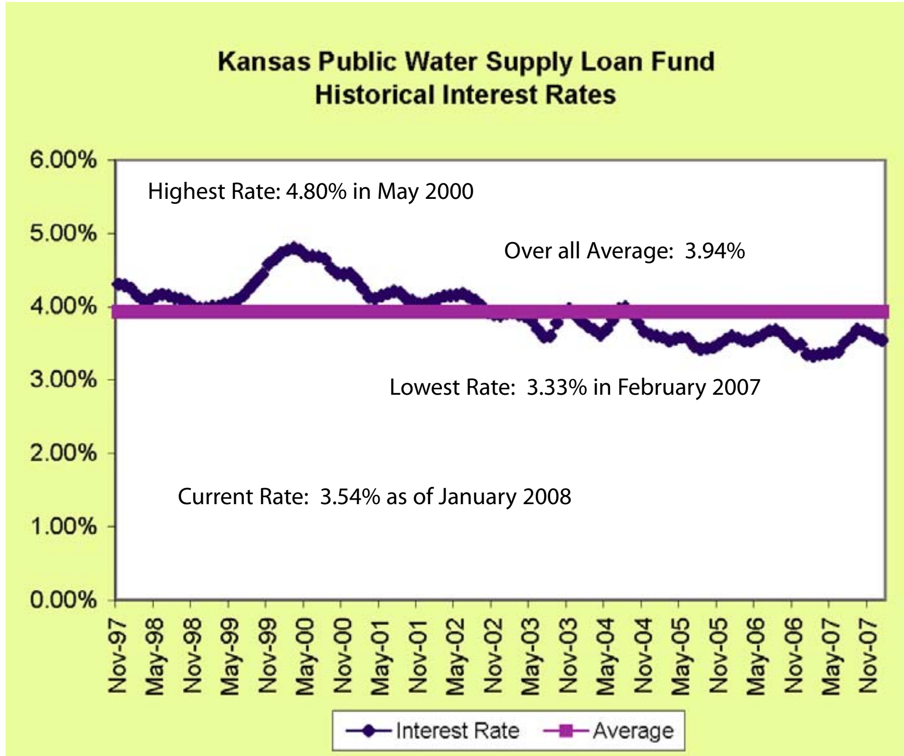
The Business Cycle Dating Committee at the National Bureau of Economic Research (NBER) defines a recession as "the time when business activity has reached its peak and starts to fall until the time when business activity bottoms out." My definition of a recession is a loss of jobs, a reduction in market valuation and lower interest rates. Hopefully, some of you may remember stagflation during the last oil crisis – but that is for a later article. Recessions are also not all evil, but that is for another time, too.

There are both opportunities and challenges with a slowing economy and a reduction in interest rates. We have previously indicated that the one-year Treasury Bill (T-Bill) is a good indicator of investment rates available to Kansas Municipalities including rural water districts, cities, counties and other public entities. One of the challenges during this period of declining interest rates is how to invest a municipality's idle funds. The chart on the previous page, "One Year Treasury Bills," demonstrates that since January 1980 the average one-year T-Bill rate has been almost 6.38%. For the past 10 years that rate has been about 3.80%. The one year T-Bill bottomed out at 1.01% in June of 2003. Since then the interest rate on the one-year T-Bill increased steadily, or held steady at about 5.00% until August 2007. The interest rate on the one-year T-Bill dropped to 3.48% during that month. This did not happen due to mere chance. It was in August



2007 when the magnitude of the sub-prime loan debacle was finally being realized. There was a real flight to safe investments. The T-Bill is unconditionally guaranteed by the United States Government. The United States Government can always print more dollars. The problem is that the dollar may not be worth much, but again, that will have to wait for another article. As of January 23, 2008 the one-year T-Bill rate was 2.83%. Because of the drop in the one year T-Bill interest rate a municipality can expect interest income to decline in the near term. Plus, the market expects the Federal Reserve to cut the fed funds rate by another .50% during the week of January 28. By the time this article is published, this action or non-action will have taken place with the antecedent results. We shall see what happens.

The opportunity in a declining interest rate market is the opportunity to borrow money at a lower cost. In fact, this is the basis for the Federal Reserve's cut in interest rates The intent is to get the economy going by entities borrowing money, spending it on capital investment and creating jobs to produce the capital investment. The chart above, "Bond Buyer Index of 20 GO Bonds," demonstrates that since January 1980 the average for this index has been almost 6.75%. The 20 Bond Buyer Index tracks the prices of a selected group of municipal bonds. Remember that the average for the same period for one year T-Bills has been about 6.38%, a difference of only 0.37%. Historically, this means most municipalities' borrowing rate is almost the same as its investment rate. For the past 10 years the rate on this index has been about 4.90%. For the past 10 years the average disparity between the expected borrowing rate and investment rate has increased (remember, the 10 year average for the one year T-Bill is 3.80%, a difference of 1.10% with the Bond Buyer's Index). This demonstrates that lower interest rates are not always in the best interest of a municipality.



The Bond Buyer Index bottomed out at 4.11% in December 2006. Since then the interest rate on the Bond Buyer Index steadily climbed or held steady at about 4.60% until September 2007. The interest rate on the Bond Buyer Index dropped to 4.50% during that month. Even though it took this index a month longer to adjust than for one-year T-Bills, the cause was the same: a flight to safety! Historically, public entities have a very low default rate on their debt instruments if used for a purely public purpose. The default rate is the percentage of bond issues that no longer pay principal and interest as a percentage of all bond issues. Those municipal bond issues that are considered pass-through financings, such as Industrial Revenue Bonds (IRBs) have a much higher default rate. A pass-through financing is done by a municipality on behalf of another entity as a guarantor, usually a private entity. The municipality does not have the legal obligation to pay for the debt obligation, therefore, when the underling entity no longer pays for the principal and interest on the bonds, neither does the municipality. A default on a pass-through financing will not affect a municipality's credit rating (unless, of course, the municipality guaranteed the bond issue for whatever reason). As of January 23, 2008 the Bond Buyer Index rate was 4.15%; almost at its all time low.

Since interest rates are so low, now is the time to investigate the possibility of refinancing a municipality's outstanding debt. I recommend administrators contact the organization's financial advisor if the municipality has debt outstanding that has interest rates for certain maturities in excess of five percent. The financial advisor should be able to calculate the possible savings from a debt refinancing.

There are three reasons to do a debt refinancing: 1) actual dollar savings; 2) restructuring of debt service payments, and 3) re-doing restrictive covenants. For actual dollar savings we recommend a present value of the cash savings of at least three percent of the outstanding debt being refinanced or an actual present value savings of $500,000 in dollar savings. The present value of the cash savings is the value of those savings in the future discounted back to the closing date at the average interest rate on the bonds. Some financial advisors recommend a present value savings of at least two percent. Under every circumstance in a dollar savings refinancing the present value of the dollars saved net of expenses should be higher than the expenses charged for doing the transaction. These fees are negotiable and often times a refinancing is easier to do than the original bond issue.

Be careful of refinancing structures that take annual principal payments to semi-annual principal payments. This structure will demonstrate a cash savings even if interest rates do not change. That is because organizations are paying debt off at a faster rate in a semi-annual principal structure versus an annual principal structure. Borrowers will also want to make sure that the present value savings is net of expenses prior to authorizing a financial advisor to proceed.

If the financial advisor now wants to become the underwriter in a refinancing it is because they will get a higher fee for changing roles. A financial advisor acts on behalf of the issuer of the debt. The financial advisor's most important responsibility is get you the lowest interest rate possible. An underwriter has to sell the bonds to someone who wants the highest rate possible. Who's best interest is the underwriter looking out for? The person that comes to see you will state that you are. The person in his/her back office that is setting the interest rates is looking out for the buyer of the bonds. Who wins out in this negotiation? With a financial advisor an administrator can be assured that only the municipality's best interests are being considered.

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The chart on the previous page, "Kansas Public Water Supply Interest Rates," delineates an average interest rate for the Kansas Public Water Supply Revolving Loan Fund of 3.97% since its inception in 1997. It was as high as 4.80% in May 2000 and as low as 3.33% in February 2007. As of the date of this publication the interest rate was 3.54%. The loan fund is available to all Kansas municipalities for those projects that qualify. It has a 20-year amortization and only a one-quarter percent loan origination fee. Without a doubt this is the least expensive way to finance water projects in Kansas (remember the index for the general obligation bonds is currently 4.15%, plus there would be fees). In addition, Rose Mary Saunders and I are available to assist with the loan application free of charge. Please give us a call at 316/ 264-3400 should there be any questions or need our assistance. Also, stop by our booth no. 167 at the 2008 KRWA Conference in Wichita. We would be pleased to discuss the Revolving Loan Fund or other funding options.