

The FISCAL REPORT an informational update

**"IF IT'S A GOOD TIME TO REFINANCE YOUR HOME, IT'S PROBABLY
A GOOD TIME FOR THE SCHOOL DISTRICT TO REFINANCE AS WELL"**

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During the 1980s, school districts became accustomed to interest rates on their lease purchase obligations in the range of 8% to 9%. The capital markets have seen a dramatic decline in interest rates during the last five years or so. Rates for 20-year AA-rated general obligation bonds (a good benchmark) have ranged from a high of 9.20% on October 16, 1987, to 5.30% on February 26, 1993. Therefore, many school districts who entered into lease obligations at rates in the 6% to 7% range during the last year or so, were quite pleased. However, because rates have continued to decline during the last year, even recently incurred financing obligations may be effectively refinanced. Lowering the interest cost 2% on a lease obligation with an outstanding principal balance of \$300,000 and a remaining term of 5 years, produces total savings of approximately \$19,000, depending on the specific rates.

In order to determine if refinancing is effective, four factors need to be taken into account: (1) the differential between the current interest rate and the refinancing rate; (2) any costs of refinancing; (3) the remaining term of the lease, and (4) any prepayment penalty which would be due on the existing lease.

The value of refinancing relative to the interest rate differential will vary according to the size of the outstanding lease obligation. In other words, the savings from refinancing is a percentage of the lease obligation, so whereby a 2% interest rate reduction on a \$10,000 obligation with one year left is only \$200, but for a \$500,000 obligation, would be \$10,000. This is important relative to considering the costs of refinancing. The costs of refinancing should be included in the refinanced amount, and of course, the result should be lower payments than the original lease. Occasionally, a lender will offer an attractive interest rate, but the costs of the refinancing (fees or a discount) will eliminate any savings. Also, a district should consider staff time in evaluating a refinancing. Some lenders have cumbersome paperwork requirements that can make the cash savings seem insignificant. No item should be lease financed for a period of time beyond its useful life. However, occasionally in a refinancing, a district will want to extend the payments over a longer period of time than the original lease to reduce the annual budget impact. For some districts, this is an appropriate budget strategy. However, from a finance viewpoint, a simple principle applies. The longer the period debt is outstanding, the more interest owed. Therefore, in a refinancing solely to generate net savings, typically the refinanced lease would not extend beyond the original term. Prepayment penalties run a wide gamut, from as much as 5% of the outstanding balance to none at all. Just as costs of refinancing affect the amount of savings to be generated, so do prepayment penalties.

Additionally, all financing should be bid just as any other vendor services. There is a wide range of interest rates currently being offered by lease providers, sometimes varying by as much

as 1% to 1.5%. As a benchmark, currently lease-purchase agreements can be had with a 1-year rate as low as 3.65%, up to 6.10% for a 12-year term, with no fees or discount.

In conclusion, refinancing is a decision governed by the numbers. In order to determine the net savings, simply compare the annual payment on the current lease obligation to the payment for the refinanced lease (which should be based on financing the prepayment of the existing lease, including any penalty, and all costs of the refinancing). Whether to refinance is one of the few decisions that really is black or white, and should never put a district in the red.

Interest Rates Have Declined As Much As 1% From A Year Ago



