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Bond Proceeds in a Rising Interest Rate Environment

Investment, Expenditures and Arbitrage Rebate

ICCCFO Spring Conference

Starved Rock Conference Center

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Bond Proceeds Overview

- Arbitrage
- Issuance Considerations
- Post-Issuance Considerations

Arbitrage Basics

- General Rule
  - Investment of bond proceeds in an investment earning a yield materially higher than the yield on the bonds causes the bonds to be arbitrage bonds
  - Federal government is providing a subsidy through lower borrowing costs and forgoing tax revenues so governmental issuer should not get a double benefit through arbitrage
- Effect
  - If bonds are arbitrage bonds, the interest on the bonds will not be tax-exempt to the holders of the bonds
  - Problem – The college told bond holders that the interest would be tax-exempt
- Exceptions exist to allow earning arbitrage

Two Key Arbitrage Questions

- Is it lawful for the College to Earn Arbitrage?
- If yes, is it lawful for the College to Keep the Arbitrage Earned?

Can the College Earn Arbitrage?

- Three-Year Temporary Period
- Requirements
  - Time Test: 5% within 6 months
  - Expenditure Test: 85% within 3 years of issue date
  - Due Diligence Test: Proceed with due diligence to expend proceeds
- Based on reasonable expectations at the time of issuance

Drawdown Schedule

Quarter	Beginning Balance	Plus Estimated Investment Earnings	Less Drawdown	Ending Balance
Upon Closing (reimbursements)	$_____,000	NA	NA	$____,000
First (after Closing)	_____,000	________	________	________
Second	________	________	________	________
Third	________	________	________	________
Fourth	________	________	________	________
Fifth	________	________	________	________
Sixth	________	________	________	________
Seventh	________	________	________	________
Eighth	________	________	________	________
Ninth	________	________	________	________
Tenth	________	________	________	________
Eleventh	________	________	________	________
Twelfth	________	________	________	________

Can the College Keep Arbitrage Earned?

- Generally must pay arbitrage profits to federal government
  - Payment referred to as “rebate”
  - When?
    - Every five years while bonds are outstanding
    - At final retirement of the bonds
- Exceptions
  - Small-Issuer Exception
  - Spend-Down Exceptions

Small Issuer Exceptions

- Exempt from rebating arbitrage based on amount of bonds issued
- Measured in year the bonds are issued
- Generally $5,000,000 of bonds issued
  - $15,000,000 for school construction

Spending Exceptions

- 6-Month Exception – No rebate payment required if all proceeds of the issue are spent within 6 months of the issue date.
- 18-Month Spend-down Exception

Period	Spend-down Requirement
6 months	15%
12 months	60%
18 months	100%

Spending Exceptions (continued)

- Two-Year Construction Spend-down Exception
  - At least 75% of the proceeds must be spent on construction expenditures

Period	Spend-down Requirement
6 months	10%
12 months	45%
18 months	75%
24 months	100%

- All spend down exceptions exclude 5% reasonable retainage

Considerations at the Time of Issuance

- Over-Issuance Concern
- Did Issuer "burden" the market by borrowing too early

§ 1.148-10 Anti-abuse rules and authority of Commissioner.

(a) ***Abusive arbitrage device*** -

(1) ***In general.*** Bonds of an issue are arbitrage bonds under section 148 if an abusive arbitrage device under paragraph (a)(2) of this section is used in connection with the issue. This paragraph (a) is to be applied and interpreted broadly to carry out the purposes of section 148, as further described in § 1.148-0. Except as otherwise provided in paragraph (c) of this section, any action that is expressly permitted by section 148 or §§ 1.148-1 through 1.148-11 is not an abusive arbitrage device (e.g., investment in higher yielding investments during a permitted temporary period under section 148(c)).

(2) ***Abusive arbitrage device defined.*** Any action is an abusive arbitrage device if the action has the effect of -

(i) Enabling the issuer to exploit the difference between tax-exempt and taxable interest rates to obtain a material financial advantage; and

(ii) Overburdening the tax-exempt bond market.

(3) ***Exploitation of tax-exempt interest rates.*** An action may exploit tax-exempt interest rates under paragraph (a)(2) of this section as a result of an investment of any portion of the gross proceeds of an issue over any period of time, notwithstanding that, in the aggregate, the gross proceeds of the issue are not invested in higher yielding investments over the term of the issue.

(4) ***Overburdening the tax-exempt market.*** An action overburdens the tax-exempt bond market under paragraph (a)(2)(ii) of this section if it results in issuing more bonds, issuing bonds earlier, or allowing bonds to remain outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes of the bonds, based on all the facts and circumstances. Whether an action is reasonably necessary to accomplish the governmental purposes of the bonds depends on whether the primary purpose of the transaction is a bona fide governmental purpose (e.g., an issue of refunding bonds to achieve a debt service restructuring that would be issued independent of any arbitrage benefit). An important factor bearing on this determination is whether the action would reasonably be taken

Ira Weiss Case

- In 2000 a Pennsylvanian School District fraudulently sold $9,600,000 of G.O. Notes.
- **The tax-exempt status of the Notes was dependent upon, among other matters, the School District reasonably expecting, on an objective basis, to spend substantially all of the proceeds of the Notes on capital projects within three years of the Notes' issuance.**
- School District explicitly advised Weiss that it had not made any final decisions on its primary capital projects and that it did not want to be locked into undertaking the controversial project of renovating or adding to an existing school building by virtue of the financing.
- Weiss reassured the School Board members that as long as they "intended" to undertake the aforementioned project, the School District was not actually required to spend the money or to do the project to keep the arbitrage profit.
- In reality, the School District intended to use the Note proceeds solely to obtain **$225,000 of interest rate arbitrage profit**.

Weiss Case (continued)

NEWS

SEC finds Weiss guilty of fraud

TRIB LIVE KIM LEONARD | Saturday, Dec. 3, 2005 12:00 a.m.

Longtime government lawyer Ira Weiss has been found guilty of securities fraud for mishandling the sale of $9.6 million in construction bonds for a Lawrence County school district, federal authorities said Friday.

The U.S. Securities and Exchange Commission yesterday ordered Weiss to pay the commission $9,509.63, plus interest in fines and fees.

The amount is tied to Weiss' earnings in a deal with the Neshannock School District. The order overturns a February decision by an administrative-law judge to dismiss the case.

Weiss -- who has represented numerous Pittsburgh-area school districts for decades and is a former Allegheny County solicitor -- is only the fourth bond counsel nationwide to be named in an SEC-enforcement action, said Mark R. Zehner, an attorney with the commission's enforcement division in Philadelphia.

Ira Weiss Case (continued)

- Outcomes:
  - School District
    - $150,000 Settlement with the IRS to keep the bonds tax exempt
    - $28,000 Fine to the SEC
  - Ira Weiss
    - Found guilty of fraud by the SEC
    - $9,500 Fine to the SEC
    - $9,000 Penalty to IRS
  - Investment Banker
    - $15,000 Fine to the SEC
    - Banned from the securities business

Bond Proceeds Remaining after Temporary Period

- After 3 years from the closing date (upon expiration of the Temporary Period), tax-exempt bond proceeds:
  - must be yield restricted
  - may not be invested in investments guaranteed by the federal government (such as FDIC-insured CDs).
    - Exception: may invest in U.S. Treasury Securities

Post-issuance compliance tips:

- **Arbitrage:**
  - Obtain computation of bond yield and establish procedure to track investments
  - Monitor compliance with 6-month, 18-month or 2-year spending
  - Arrange for timely computation of rebate liability and, if rebate is payable, for timely filing of Form 8038-T and rebate payment
  - May engage outside arbitrage rebate consultants to do computations
- **General:**
  - Monitor compliance with temporary period expectations for expenditure of bond proceeds (to evidence spending proceeds with "due diligence")
  - Have you taken any actions re: the financed project – Sale, leases or management contracts

Questions

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Bond Market Analysis

The MMD "AAA" Index

- The Municipal Market Data (MMD) Index is a daily index of AAA-rated municipal bond rates
- Issuers' bond yields are priced relative to the MMD
  - The relative difference is called the "spread" to the MMD
  - The spread varies due to the following:
    - Credit rating
    - Bank qualification
    - Length of maturity
    - Coupon or interest rates

Recent Variables Impacting the Municipal Bond Market

FED Reserve Policy
Fed Funds Rate

Global Political Events - Ukraine

Inflation Expectations

Health of National, State and Local Economies

State of Illinois Political Challenges

Bank Qualification

Municipal Bond Supply and Demand

Europe

Chicago's Fiscal Challenges – Pension Issues

Municipal Bankruptcies (e.g. Detroit, Puerto Rico)

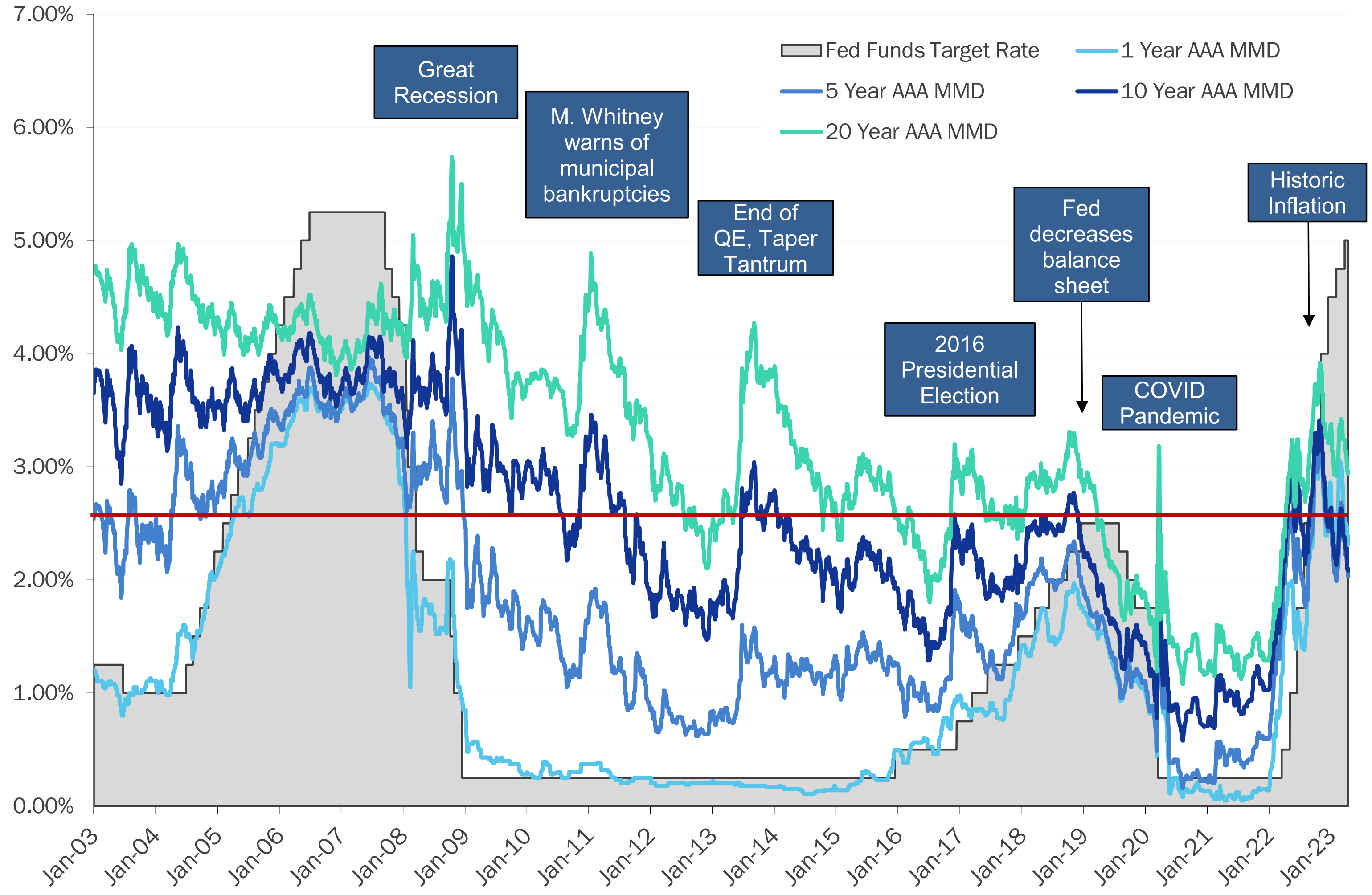
Credit Ratings of State and Local Governments

Level of Federal and State Income Taxes

As of: 3/31/23

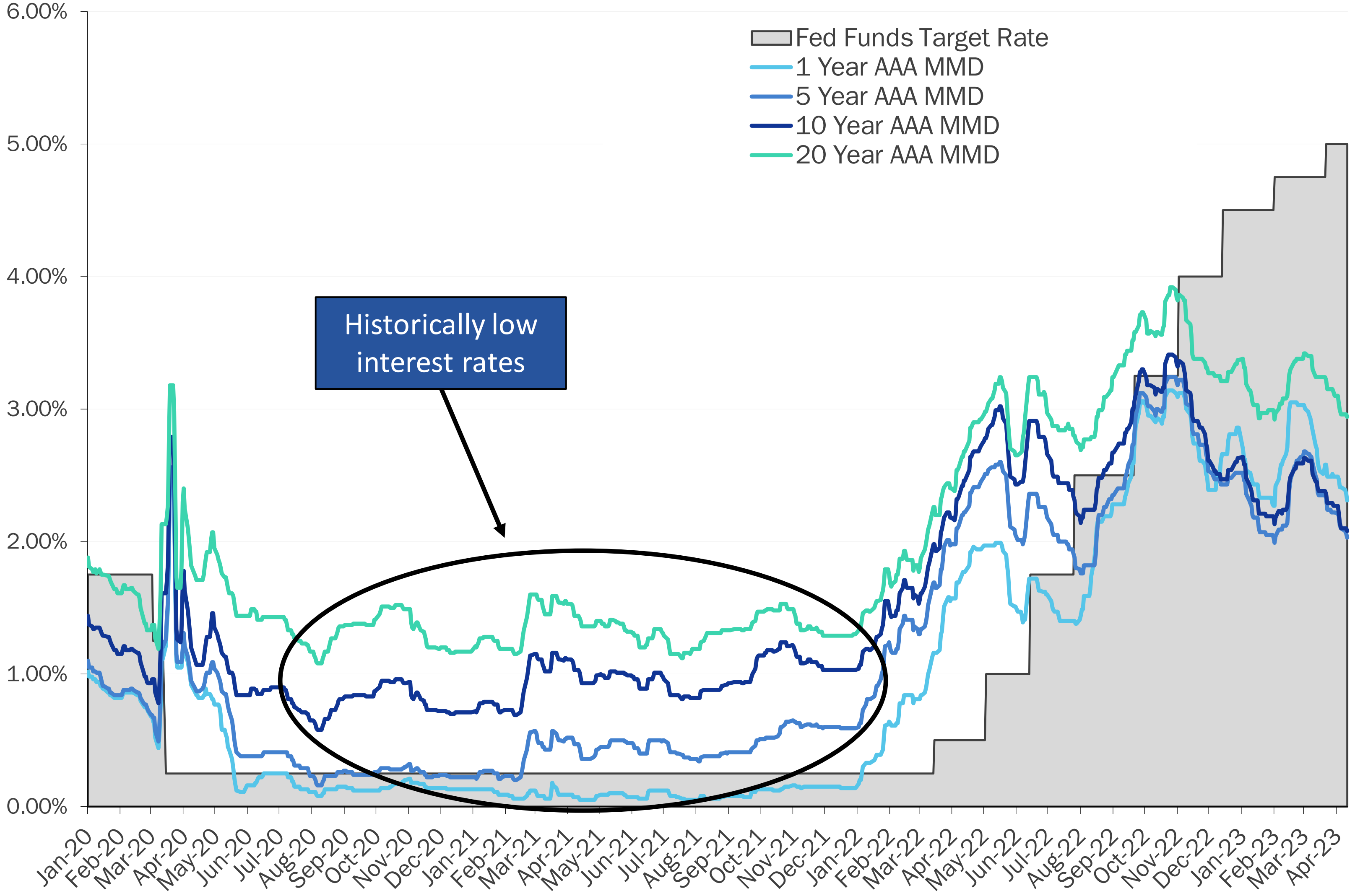
Interest Rates* Since 2003

- The 10yr MMD 20-year average is 2.57% (see red line below).



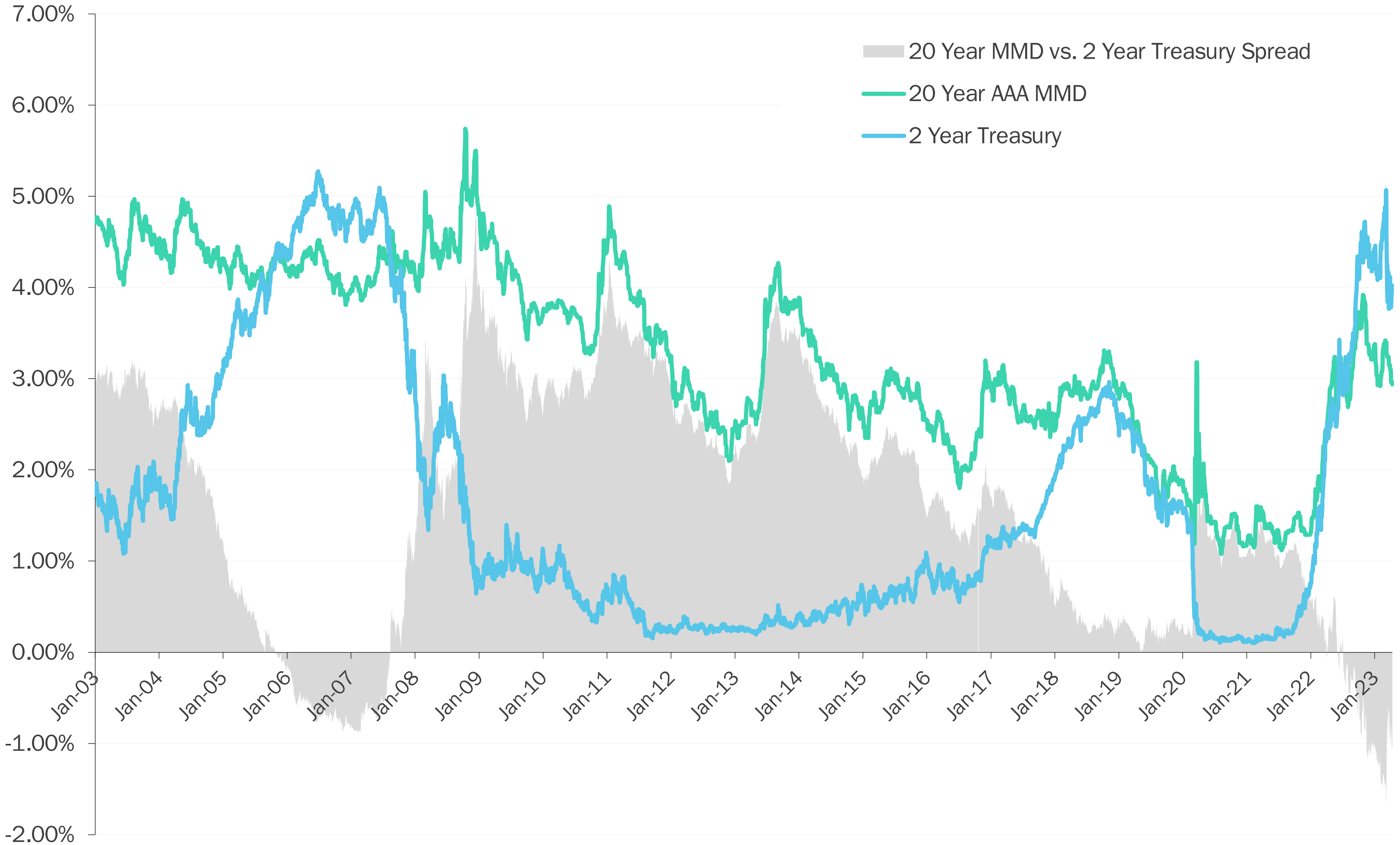
*The Municipal Market Data "MMD" is a AAA municipal bond market index produced by TM3. As of April 13, 2023.

Interest Rates* Since 2020



*The Municipal Market Data "MMD" is a AAA municipal bond market index produced by TM3. As of April 13, 2023.

20-year MMD vs. 2-year Treasury Spread



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Investing Bond Proceeds

Benefits of Investing Bond Proceeds

Increased earned interest

Establishes reliable interest earnings projections

Guided Establishes a scheduled flow of funds

Benefits of Investing Bond Proceeds (Continued)

- An example of a $10,000,000 issuance

Keeping Liquid

Need Date	Amount	Rate	Interest Earned
05/01/19	$1,000,000.00	2.05%	$9,267.12
06/01/19	$1,000,000.00	2.05%	$11,008.22
07/01/19	$2,000,000.00	2.05%	$25,386.30
08/01/19	$1,000,000.00	2.05%	$14,434.25
09/01/19	$1,000,000.00	2.05%	$16,175.34
10/01/19	$500,000.00	2.05%	$8,930.14
05/01/20	$1,500,000.00	2.05%	$44,734.93
06/01/20	$1,000,000.00	2.05%	$31,564.38
07/01/20	$1,000,000.00	2.05%	$33,249.32
	$10,000,000.00		$194,750.00

Investing to a spend schedule

Need Date	Amount	Rate	Interest Earned
05/01/19	$1,000,000.00	2.35%	$10,623.29
06/01/19	$1,000,000.00	2.41%	$12,941.37
07/01/19	$2,000,000.00	2.45%	$30,339.73
08/01/19	$1,000,000.00	2.49%	$17,532.33
09/01/19	$1,000,000.00	2.52%	$19,883.84
10/01/19	$500,000.00	2.56%	$11,151.78
05/01/20	$1,500,000.00	2.70%	$58,919.18
06/01/20	$1,000,000.00	2.72%	$41,880.55
07/01/20	$1,000,000.00	2.73%	$44,278.36
	$10,000,000.00		$247,550.41

- In this example the college district would earn an additional $52,800 by investing the bond proceeds.

How to Invest Bond Proceeds

- First, you will need a spend schedule from your construction manager or architect
- Open separate account for bond proceeds to be directly deposited into at closing
  - Allows the bond proceeds to be segregated from operating funds.
  - Track transfer of expenses against the spend down exceptions.
  - Ability to keep bond proceeds investments separate from operating investments.
  - Easily compare the interest earned from the bond proceeds versus the maximum allowable rate from the issuance (Arbitrage).

How to Invest Bond Proceeds

- Know what investments are allowable under the district's investment policy and Illinois State Statute
- Determine how much of the proceeds will need to be liquid in order to cover unexpected expenses or changes in the spenddown schedule
  - The liquidity can be in a money market account or an investment that offers liquidity, such as a government agency or treasury.
  - This amount may be different for each issuance but 10-15% is a good rule of thumb to have in investments that are more liquid.

Reporting for Bond Proceeds

Investment Earnings Detail

$2,258,108.13	Current Portfolio Interest Income Estimate
$1,197,876.17	Potential Interest Income on Balances (4.75%)
$3,455,984.29	Estimated Interest Income (Not including Rebate)
4.268%	Total Return for Arbitrage Purposes
319	Weighted Avg Life of Future Projected Expenses

Investment Proceeds Information

	09/28/22	Closing Date - Investment Proceeds Received
	$60,002,244.65	Investment Proceeds Received
+	$2,951,470.78	Total Interest Income Net of Rebate
=	$62,953,715.43	Total Funding Available as of 04/07/23
-	$3,682,935.26	Cumulative Expenses Through 04/07/23
=	$59,270,780.16	Outstanding P & I Net of Rebate after 04/07/23

Portfolio Arbitrage Status

Yield Restriction: **The bond proceeds currently fall under the three year temporary period and are therefore not yield restricted.**

Arbitrage Rebate: **The proceeds are subject to arbitrage rebate. The district has not met the two year exception and does expect to pay arbitrage.**

$3,455,984.29	Estimated Interest Income (Not including Rebat	$3,455,984.29	4.268%	Current Interest Estimate for Arbitrage Purposes
$504,513.52	Anticipated Arbitrage Rebate Liability	$2,951,470.78	3.670%	Maximum Interest Limited by Arbitrage Yield
$2,951,470.78	Total Interest Income Net of Rebate	$504,513.52	0.597%	Potential Arbitrage Rebate Liability

Regulatory Requirement			Actual/Projected Portfolio Status			Regulatory Status as of 04/07/23
Estimated Spend-Down Requirements			Cumulative Expenses			$3,682,935.26 Expenses to Date: 5.80%
03/28/23	10%	$6,000,224.47	5.80%	$3,682,935.26	Actual Expense	Not met regulatory requirement
09/28/23	45%	$27,001,010.09	21.77%	$13,814,577.26	Projected Expense	Not met regulatory requirement
03/28/24	75%	$45,001,683.49	51.35%	$32,584,194.26	Projected Expense	Not met regulatory requirement
09/28/24	100%	$63,458,228.94	86.73%	$55,034,170.26	Projected Expense	Not met regulatory requirement

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