What's With These Interest Rates?

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Agenda

Market Update – Investing

Investment Strategy Considerations

Investing Bond Proceeds – Arbitrage Rebate

Financing and Investment Case Study

Refundings

Investing Bond Proceeds – Arbitrage Considerations

What does Arbitrage Mean? What about Rebate?

- What is ***arbitrage***?
  - Difference between (i) what would have been earned if tax-exempt bond proceeds were invested at bond yield and (ii) the earnings on the investment of such tax-exempt bond proceeds in higher yielding securities
- What is ***rebate***?
  - An issuer must pay (rebate) arbitrage profits to the federal government
- Are there exceptions to the rebate?
  - Small Issuer Exception
  - Spend-Down Exceptions

Small Issuer & Spend-Down Exceptions

- What is the ***small issuer exception***?
  - An issuer of bonds (e.g., community college) does not have to rebate its arbitrage profits to the federal government if the issuer does not issue more than **$5 million** of bonds in a calendar year (***increased to $15 million for community college construction***)

- What are the ***spend-down exceptions***? The spend-down requirements are based on **actual facts and not reasonable expectations**
  - **6-month exception** – 100% of gross bond proceeds spent within 6 months of issuance
  - **18-month exception**
    - At least 15% of gross bond proceeds spent within 6 months of issuance
    - At least 60% of gross bond proceeds spent within 12 months of issuance
    - 100% of gross bond proceeds spent within 18 months of issuance
  - **2-year exception***
    - 10% of the construction proceeds spent within 6 months of the issuance
    - 45% of such proceeds spent within 1 year
    - 75% of such proceeds spent within 18 months
    - 100% of such proceeds spent within 2 years

**Note: The 2-year exception is related to construction issues, which results in slightly different considerations and definitions of certain terms.*

Spend-Down Exceptions (cont.)

- **"Reward"** for spending bond proceeds quickly
- Allowed to keep positive arbitrage
- Must meet each benchmark, no catch-up allowed

6-Month		18-Month		2-Year (ACP)	
All gross proceeds		**All new money**		**Construction issues**	
✓ 6 months	100%*	✓ 6 months	15%	✓ 6 months	10%
		✓ 12 months	60%	✓ 12 months	45%
		✓ 18 months	100%**	✓ 18 months	75%
				✓ 24 months	100%**

- ** Exceptions for 5% of the proceeds of the issue if spent within one year*
- *** De minimis (lesser of 3% or $250K) and reasonable retainage (5% spent in 12 months) exceptions may apply for last benchmark*

Spending Benchmarks – 2-Year Test

- 2022 Bonds must be a “Construction” issue
  - At least 75% of the project is construction
- Must meet each benchmark, no catch-up allowed
- ACP = Available Construction Proceeds
  - Project Fund plus Expected Earnings

2022 Project Fund	$25,000,000
Expected Earnings*	$1,000,000
ACP - Denominator	**$26,000,000**

Benchmark Date		% Required Expenditures	$ Required Expenditures	$ Actual Expenditures	Met Benchmark?
Issue Date	10/26/2022				
6 months	4/26/2023	10%	$2,600,000	?	Yes / No
12 months	10/26/2023	45%	$11,700,000	?	Yes / No
18 months	4/26/2024	75%	$19,500,000	?	Yes / No
24 months	10/26/2024	100%**	$26,000,000	?	Yes / No

For illustrative purposes only
** Based on reasonable expectations as of the issue date*
*** De minimis (lesser of 3% or $250K) and reasonable retainage (5% spent in 12 months) exceptions may apply for last benchmark.*

Arbitrage – Spend-Down Tracking

- **Background** – The federal government's regulatory framework prevents borrowers from inadvertently issuing arbitrage bonds and therefore, earning a profit from the issuance of tax-exempt bonds. Bonds which are issued for the purpose of earning arbitrage are referred to as "arbitrage bonds" and cannot be tax-exempt.

- So, issuers of tax-exempt bonds must (generally) qualify for a three-year temporary period exception, which allows bond proceeds to be invested at an unrestricted yield for three years

- Qualification for the three-year temporary period is based on **reasonable expectations** at the time of the bond issuance and includes three tests
  - Must **reasonably expect** to spend bond proceeds as follows:
    - *Expenditure Test — 85% within 3 years*
    - *Time Test — 5% within 6 months*
    - *Due Diligence Test*

- Community colleges must keep records of **<u>how</u>** the bond proceeds were invested, **<u>when</u>** the bond proceeds were spent and **<u>what</u>** facilities/improvements the bonds funded

Arbitrage – Unspent Bond Proceeds

- After three years from the closing date of the bond issue (upon expiration of the three-year temporary period), tax-exempt bond proceeds:
  - Must be yield restricted; and
  - May not be invested in investments guaranteed by the federal government (such as FDIC-insured certificates of deposit)
    - *Exception:* may invest in U.S. Treasury securities and certain municipal securities

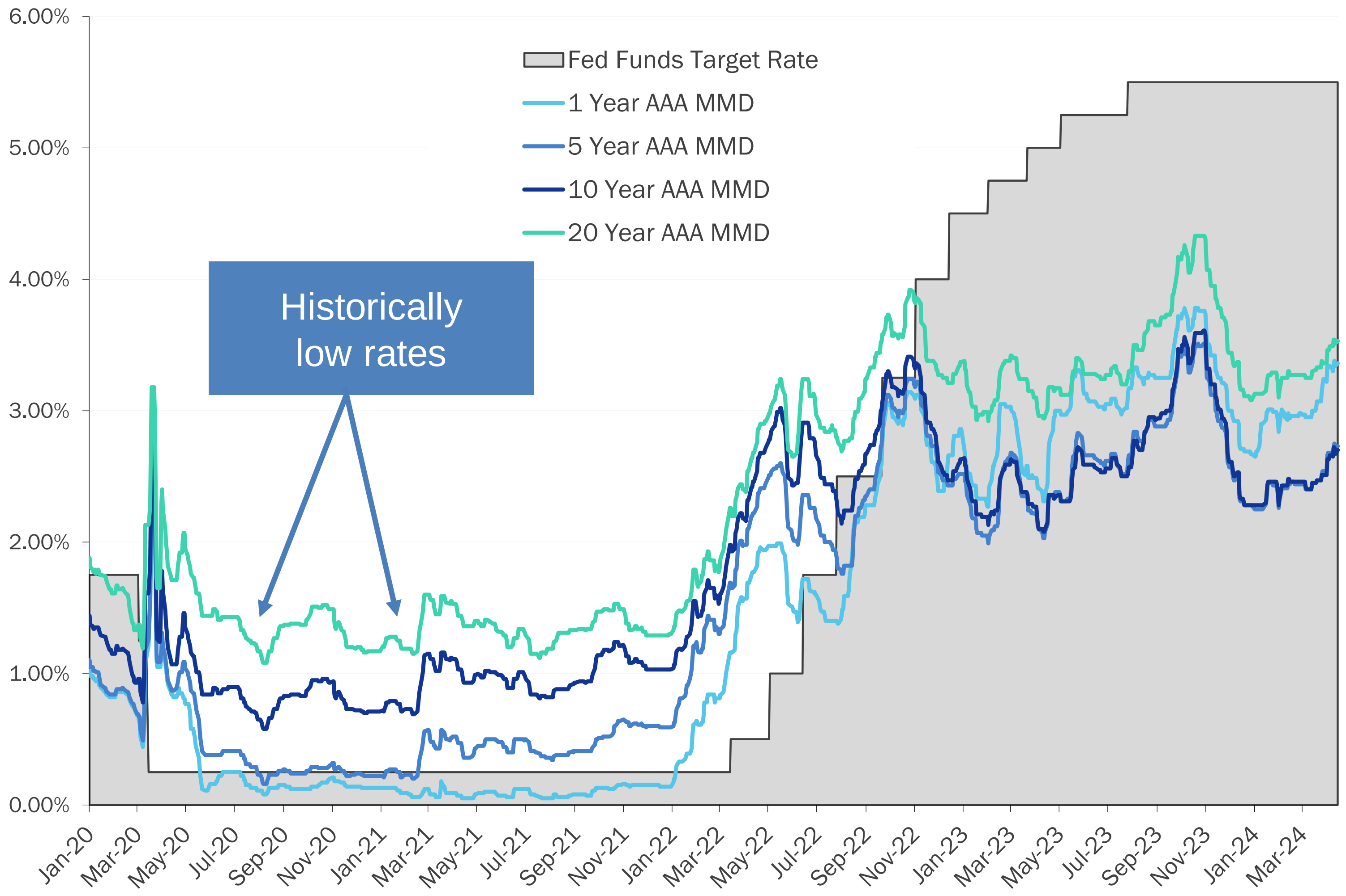
Tracking Bond Proceeds

- **Arbitrage is not a bad thing!**
  - It means the College maximized how much could be earned. Not knowing how much is owed and making the payment is where problems would begin.
  - Make sure the bond proceeds are deposited in a separate account

Arbitrage – Checklist for Compliance

- ✓ Interest earned and expenses need to be tracked monthly to know how the college is trending towards a potential rebate and if the spend down exception can be met
- ✓ If small issuer exemption is not applicable, track investment return against bond yield
  - ✓ Tracking on a monthly basis will also help the district identify the amount that should be left in the account to make the necessary rebate payment
- ✓ If small issuer exemption is applicable, monitor compliance with 6-month, 18-month or 2-year spending exceptions to rebate, if relevant
- ✓ Monitor compliance with three-year temporary period expectations for expenditure of bond proceeds
- ✓ Arrange for timely computation of rebate liability and, if rebate is payable, for timely filing of Form 8038-T and rebate payment

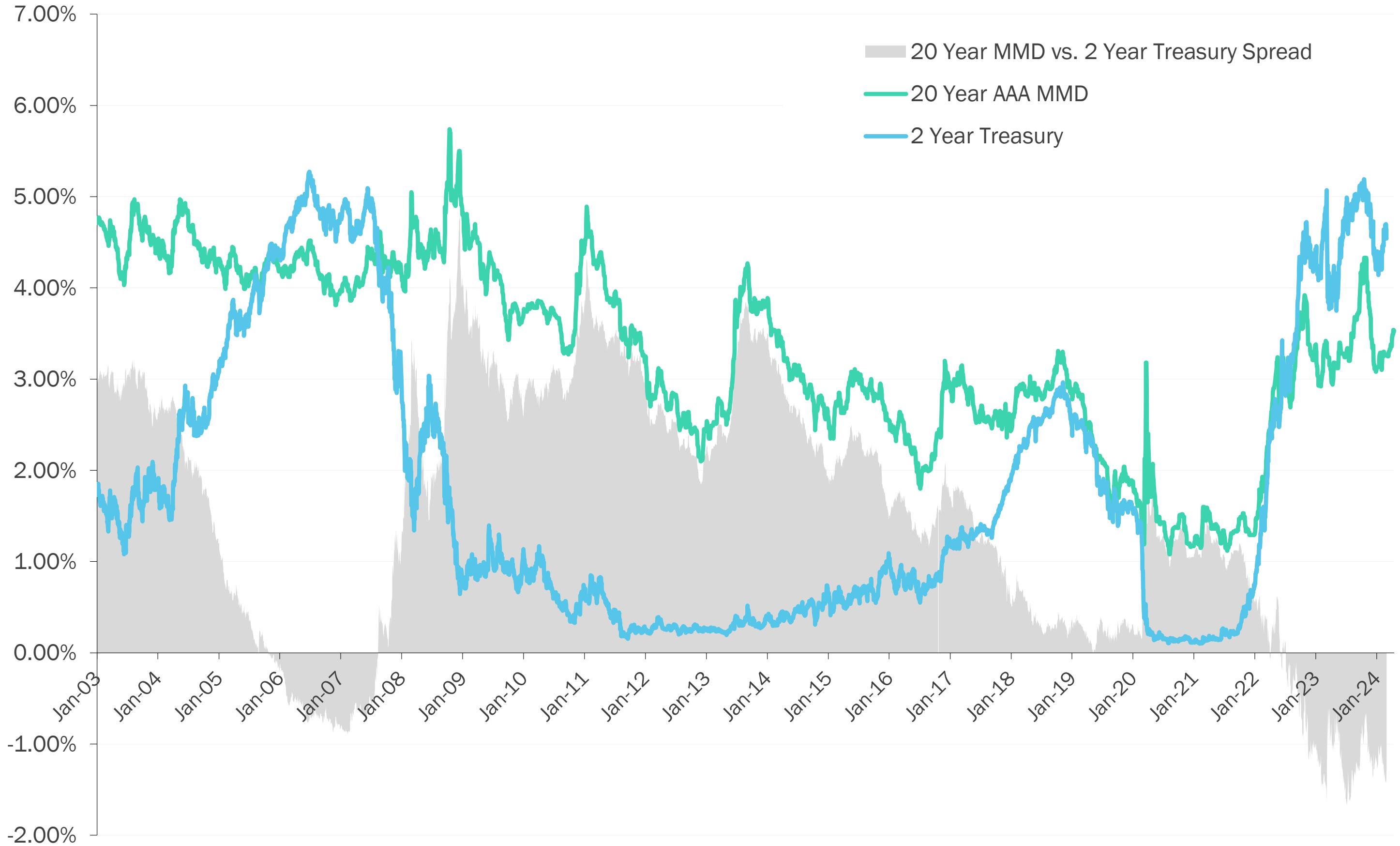
Interest Rates Since January 2020



*The Municipal Market Data "MMD" is a AAA municipal bond market index produced by TM3. As of April 16, 2024.

Potential for Positive Arbitrage (subject to meeting exemptions)

Long-Term Borrowing Rates Versus Short-Term Investment Rates



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Financing and Investment Case Study

Case Study

Fiscal Year	Scenario A: Debt Certificates, Series 2023 (1)	Scenario A: PROPOSED Debt Certificates, Series 2024 (1)	Scenario A: Total DC Debt Service	Scenario B: PROPOSED Debt Certificates, Series 2024 (1)	Scenario B: Total DC Debt Service
2024	$ -	$ -	$ -	$ -	$ -
2025	1,581,250	889,080	2,470,330	2,492,532	2,492,532
2026	779,000	1,650,150	2,429,150	2,493,213	2,493,213
2027	780,250	1,653,525	2,433,775	2,492,713	2,492,713
2028	776,125	1,659,525	2,435,650	2,489,713	2,489,713
2029	781,500	1,653,275	2,434,775	2,489,088	2,489,088
2030	776,375	1,654,775	2,431,150	2,490,588	2,490,588
2031	780,750	1,653,775	2,434,525	2,493,963	2,493,963
2032	779,500	1,655,150	2,434,650	2,489,213	2,489,213
2033	777,750	1,653,775	2,431,525	2,491,213	2,491,213
2034	780,375	1,654,525	2,434,900	2,489,713	2,489,713
2035	1,406,250	1,033,150	2,439,400	2,489,588	2,489,588
2036	1,409,500	1,030,400	2,439,900	2,490,588	2,490,588
2037	1,405,375	1,031,025	2,436,400	2,492,463	2,492,463
2038	1,408,750	1,029,900	2,438,650	2,490,088	2,490,088
2039	1,409,375	1,031,900	2,441,275	2,493,213	2,493,213
2040	1,407,250	1,031,900	2,439,150	2,491,588	2,491,588
2041	1,403,600	1,034,775	2,438,375	2,490,088	2,490,088
2042	1,408,700	1,030,525	2,439,225	2,493,338	2,493,338
2043	1,411,600	1,032,831	2,444,431	2,493,081	2,493,081
2044	1,402,500	1,031,381	2,433,881	2,493,788	2,493,788
	$ 22,665,775	$ 26,095,343	$ 48,761,118	$ 49,829,763	$ 49,829,763
Estimated Proceeds:	$ 14,500,000	$ 17,500,000	**$ 32,000,000**	**$ 32,000,000**	
Estimated TIC (1):	4.05%	4.63%		4.73%	
Estimated Investment Earnings (2):			**$ 2,031,549**	**$ 1,679,180**	
Estimated Debt Service Less Investment Earnings (1)(2):			**$ 46,729,569**	**$ 48,150,583**	

(1) Rates based upon market conditions and recent bond sales as of October 17, 2023 which PMA believes to be accurate and reliable.

(2) Assuming $1mm is drawn in the first year and then level quarterly draws over a 12-month period. Investment rates as of 10/25/23. Scenario B limits investment earnings to arbitrage yield.

NOTE: Scenarios where a greater portion of the overall debt is issued in advance of the expenditures of the proceeds will likely result in higher fees earned by the investment manager of the debt proceeds.

Case Study – Draw Schedules

- The investments are laddered to maximize the benefit of the small issuer exception and to permit the college to achieve the draw schedules on the second financing.

		First Issuance - Small Issuer Exception				Second Issuance - 24 Month Construction Exception			
Quarter	**Estimated Draw Schedule**	**2023 Debt Certificate Proceeds**	**Less Drawdowns**	**Estimated Investment Earnings**	**Spend Down %**	**2024 Debt Certificate Proceeds**	**Less Drawdowns**	**Estimated Investment Earnings**	**Spend Down %**
Upon Closing (reimbursements)	$ -	$ 14,500,000	$ -	$ -		$ -	$ -	$ -	
First (after closing)	350,000	-	350,000	4,463		-	-	-	
Second	425,000	-	425,000	10,944	5.34%	-	-	-	
Third	625,000	-	450,000	17,213		17,500,000	175,000	2,297	
Fourth	3,680,000	-	113,500	5,789	9.23%	-	3,566,500	93,621	21.38%
Fifth	5,280,000	-	448,000	28,000		-	4,832,000	192,072	
Sixth	7,440,000	-	560,000	42,000	16.18%	-	6,880,000	364,640	88.31%
Seventh	9,280,000	-	7,233,500	632,931		-	2,046,500	135,581	
Eighth	4,320,000	-	4,320,000	432,000	95.86%	-	-	-	100.00%
Ninth	400,000	-	400,000	45,000		-	-	-	
Tenth	200,000	-	200,000	25,000		-	-	-	
Total:	**$ 32,000,000**	**$ 14,500,000**	**$ 14,500,000**	**$ 1,243,339**		**$ 17,500,000**	**$ 17,500,000**	**$ 788,210**	

Refundings

Refundings – The Basics

Most bond issues are sold with an optional call provision that allow the bonds to be refinanced or paid off after a period of time

Municipal bonds are usually not callable for 8 to 10 years, unlike a mortgage which can be prepaid at any time

- ***Call Date*** – the date at which the college is allowed to pay of its outstanding bonds prior to maturity
- ***Current Refunding ,***– existing bonds are refunded within 90 days of the call date
- ***Advance Refunding*** – existing bonds are refunded 91 days or more before the call date

Under current federal law, advance refundings have to be sold with federally taxable interest rates.

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Refundings – Why are Bonds Refunded?

Bonds can be refunded for ***savings*** due to lower interest rates and/or bonds can be ***restructured*** to change the debt repayment schedule.

When refunding for savings, a typical threshold of savings target after paying costs of issuance present value savings > 3% of bonds refunded.

Most refundings are done for savings where the debt service on the new bonds is less than the old bonds, thereby creating savings.

Restructuring outstanding bonds when taking on a new project is common to manage the tax rate impact of the new project.

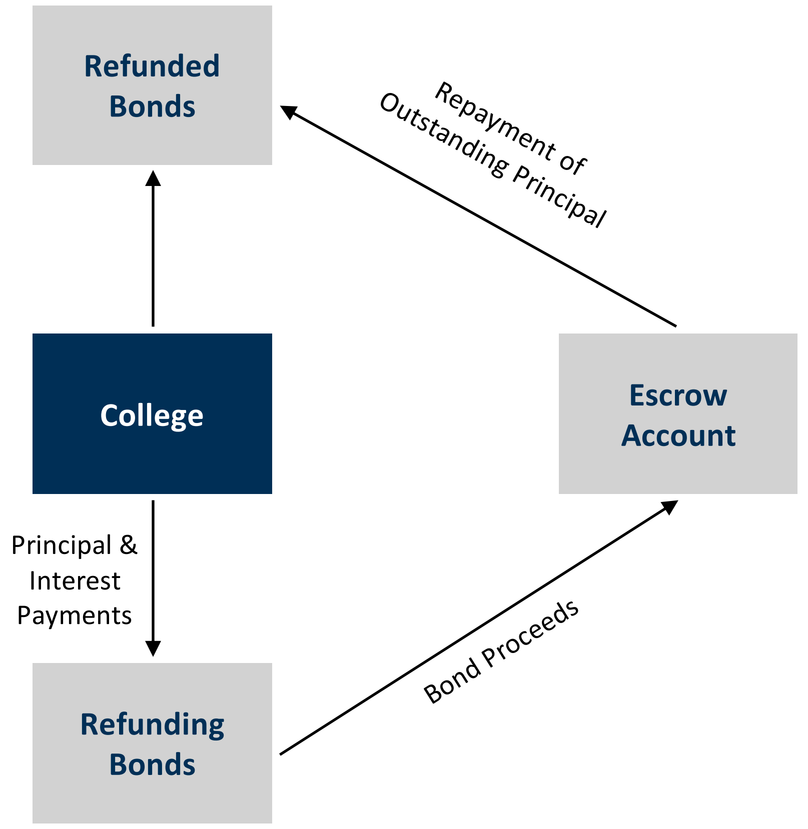
Refundings – How Does it Work?

College issues refunding bonds

New bonds generate an amount sufficient to fund a refunding escrow

The escrow consists of a combination of cash and securities (typically) that are sufficient to pay the escrow requirement of:

- Debt service (principal and interest payments on refunded bonds due before the call date)
- Outstanding principal of refunded bonds due on the optional call date



Refundings – Cash Flow vs. NPV Savings

Cash flow savings is the simple dollar amount saved in each year. It is the difference between the prior debt service and the refunding debt service

Net present value (NPV) savings is the current value of future savings at a rate of return, typically the new bond yield

Industry standard best practice is that NPV savings target should be at least 3% of the amount being refinanced

A Refunded Debt Service	B Refunding Debt Service	A - B Savings	Net Present Value Savings
4,916,912.62	4,537,984.14	378,928.48	371,103.73
4,916,351.32	4,536,490.00	379,861.32	363,955.20
3,997,163.16	3,619,090.00	378,073.16	354,334.47
3,990,858.34	3,608,290.00	382,568.34	350,665.32
3,993,989.78	3,614,090.00	379,899.78	340,564.97
3,990,850.88	3,615,690.00	375,160.88	328,916.94
3,986,267.92	3,608,090.00	378,177.92	324,244.75
3,985,390.66	3,611,490.00	373,900.66	313,501.46
3,981,694.30	3,605,290.00	376,404.30	308,611.41
3,981,218.58	3,609,690.00	371,528.58	297,864.46
3,983,295.14	3,609,090.00	374,205.14	293,345.52
3,974,406.28	3,600,840.00	373,566.28	286,455.62
2,093,378.88	1,879,040.00	214,338.88	160,761.37
51,791,777.86	47,055,164.14	4,736,613.72	4,094,325.22

PV of prior debt	**47,950,761.88**
Net PV Savings	**4,094,325.23**
Percentage savings of refunded bonds	**10.163%**

Refundings – Key Questions to Ask

1. Do we have any bonds that make sense to refinance?
2. When is our next possible opportunity to refinance?
3. If we are currently refinancing:
   - How much is the estimated savings?
     - Is savings after fees over 3% of what we are refinancing?
   - Did we consider future borrowing needs and levy?
4. If we are borrowing for new projects:
   - Did we consider interest income on project funds?

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