The Essentials

ARBITRAGE & REBATE (REAL WORLD EXAMPLES)

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Gross Proceeds

- Replacement Proceeds
  - Sinking funds
  - Pledged funds
  - Negative pledges

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Replacement Proceeds Hypo

A 501(c)(3) charter school is planning to finance an expansion to serve middle school children. The total cost is expected to be $15 million. The School has received a grant from the City for $1.5 million to cover preliminary costs and has begun a capital campaign for the project. To date it has received $1.0 million and has pledges for an additional $4 million which will come in over 5 years. The project is expected to be completed in 3 years. The School has asked if it can finance the full $15 million with bonds it expects to place with a bank.

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Questions

- How should the grant money be treated?
- Should the $1 million already received in capital campaign funds be treated differently than pledges?
- The Bank would like the capital campaign funds to be held in a restricted account at the Bank to cover debt service shortages. Is this subject to yield restriction and rebate?
- The Bank proposes 2 financial covenants:
  - The School will maintain at all times $5,000,000 in liquid assets
  - The debt service coverage ratio, measured quarterly, shall be 1:20.

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Yield Restriction

- "Yield reduction payments"
- Temporary periods:
  - Construction
  - 4R Fund
  - Minor portion
  - Bona fide debt service fund

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Hedge Bonds

- Expectation to spend the money in three years and no long-term investment strategy – out of the rule
- Otherwise: 5 year expenditure benchmarks or 95% investment in tax-exempt bonds

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Temporary Period Hypo

State plans to issue bonds to finance renovations to a large number of bridges across the State. The engineers and architects believe the projects could be completed in 3 years if all of the permits and other funding issues are resolved. The interest rates are relatively low, so the State's financial advisor is suggesting that the State move forward now with the issuance of bonds on the assurances that the necessary permits and funding will fall in place later.

Questions

- What temporary period for investing the construction proceeds would be appropriate here?
- What happens if the State does not spend all of the construction proceeds in 3 years?
- Why did someone raise the question of "hedge bonds"?

Role of Tax Certificate

- **For the "issue"**
- **Multipurpose issue rules**

Single Issue Hypo

Hospital is planning to restructure its debt in connection with financing a new cancer center. The bonds issued in 2007 can be optionally redeemed at any time, but the 2010 bonds cannot be redeemed early until 2020. The Hospital would like to publicly market the refunding bonds, but issue the new money bonds for the new cancer center through a direct bank draw-down loan to save interest costs. The Hospital wants to close both transactions on the same day.

Questions

- Does this need to be a "single issue" for arbitrage purposes?
- What if the Hospital wants to split the refundings and the new money up to better track for financial statement purposes?

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Accounting For Expenditures

- Capital expenditures
- Reimbursement expenditures
- Working capital and "proceeds spent last"
- Final allocation of proceeds to expenditures

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Accounting for Expenditures Hypo

Developer requests that the Housing Finance Authority issue bonds for a rental housing project. Prior to contacting the Authority, the Developer hired an architect to do design work and has put a deposit down to purchase the land. The housing will be part of the larger project that includes ground-floor retail. The Authority passed a resolution to provide tax-exempt bond financing for the project. The Developer has obtained a grant from the City to finance the ground floor retail. The financing pro forma indicates that the project is expected to rent up over a year-long period, so the budget includes interest beyond construction to finance revenue shortfalls.

Questions

- Can the Developer use proceeds of the bonds for the architectural expenses it already paid?
- Can the interest beyond construction be financed with bond proceeds?
- The Developer intends that the grant and its own funds will finance the retail space. How is this shown in a "final allocation"?

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Issue Price Hypo

State Agency is issuing bonds to finance several transportation projects on a negotiated basis. On the sale date the underwriter conveys to you that the underwriter sold 100% of all 2025 and beyond maturities (final maturity of the bond is 2038), but was only able to sell 5% of 2020-2023 maturities, and 25% of 2024 maturities.

Questions

- How do you determine issue price?
- What assertions must be included in the Bond Purchase Agreement?
- What documentation is needed for issue price purposes?
- Considerations
  - Competitive vs. Negotiated
  - Documentation needed when there is a single underwriter (no selling group or retail distribution) vs. selling group

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Determination of Yield

- Qualified hedges
  - Integration and Super-integration

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Swap Hypo

A City plans to issue variable rate bonds and the financial advisor has proposed that the City enter into an interest rate swap to reduce its variable rate bond exposure. The interest rate on the bonds will be a percentage of LIBOR. Under the swap, the City will pay a fixed rate to the proposed swap provider and the City will receive a variable rate based on LIBOR, but with a different formula than that on the Bonds. The City and its financial advisor want to know if the City can and should "integrate the swap."

Questions

- What happens to the yield on the bonds if the swap is integrated?
- What steps are required, from whom, and by when?

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