Arbitrage and Rebate
Real World Examples

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Refresher Hypo

A school district plans to issue $11 million in tax-exempt bonds to finance the costs of certain computer equipment, building improvements, including a new HVAC and certain other renovations, a new turf field and acquisition of certain school vehicles, including a new school bus. The bond yield is expected to be around 3.5% and, because short-term interest rates are so high, the school district is able to invest its project fund above bond yield at around 5%.

- What are some things the school district needs to consider as it plans its financing?

Refresher Hypo

Can the school district invest above bond yield?

- Temporary period qualification – reasonable expectations

If it can invest above bond yield, can it keep the arbitrage spread it makes, if any?

- Does the issue qualify for a rebate exception?
  - Small issuer
  - Spending

What are other things to think about?

- Replacement proceeds/other funds, expected investments, hiring rebate analyst, etc.

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.

Questions

1. How should the grant money be treated?
2. Should the $1 million already received in capital campaign funds be treated differently than pledges?
3. 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?
4. 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, will be 1:20.

Gross Proceeds

Replacement Proceeds

Sinking funds

Pledged funds

Negative pledges

Temporary Period/Hedge Bonds

City plans to issue bonds to finance a portion of the costs of construction of a new municipal building. Permits have been applied for but have not all be received. Construction is expected to take about 30 months. The interest rates are relatively low, so the City's financial advisor is suggesting that the City move forward now with the issuance of bonds with the expectation that the necessary permits and additional funding will fall in place later.

Temporary Period/Hedge Bonds (cont'd.)

Questions

1. How comfortable are you allowing the City to issue bonds now?
   - Reasonableness of Expectations
   - Potential mitigation techniques

2. What temporary period for investing the construction proceeds would be appropriate here?

3. What happens if the City can invest above bond yield?

Temporary Period/Hedge Bonds (cont’d.)

Questions

1. What happens if the City does not spend all of the construction proceeds in 3 years?
   - Yield Restriction and Yield Reduction Payments

2. Why did someone raise the question of “hedge bonds”?
   - Section 149(g) prohibition - hedge bonds are not tax-exempt

Hedge Bonds

Expectation to spend 85% 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

Reasonable Expectations

Single Issue Hypo

Hospital is planning to currently refund certain bonds (2009 bonds) as well as finance a new cancer center. The Hospital would like to publicly market the refunding bonds, but issue the new money bonds for the new cancer center in a bank direct placement. The Hospital wants to close both transactions on the same day. They have flexibility in the timing of the sales of each piece and could sell them both within 15 days of one another.

Questions

1. Can this be a "single issue" for arbitrage purposes?
2. What if the Hospital wants to split the refunding and the new money up to better track for financial statement purposes?

Role of Tax Certificate

For the "issue"

Multipurpose issue rules – allocating bonds to purposes of an issue

- Allocation methods for issues that include refunding bonds

Accounting for Expenditures

Housing Finance Authority plans to issue Section 142 multifamily bonds for a rental housing project.

Prior to contacting the Authority, the Borrower hired an architect to do design work and put a deposit down to purchase the land. The Authority then passed a resolution to provide tax-exempt bond financing for the project.

The housing will be part of a mixed-use development that includes ground-floor retail. The Developer has obtained a grant from the City to finance the ground floor retail.

The financing budget includes a deposit to a capitalized interest fund calculated to cover interest through 12-months after completion.

Accounting for Expenditures (cont'd.)

Questions

1. Can the Borrower use proceeds of the bonds for the architectural expenses or land down payment that was already paid?
   - Reimbursement rules
   - Preliminary Expenditures

2. How much interest can be financed with bond proceeds?
   - Capital expenditures vs. working capital
   - Slightly differing capitalized interest rules for governmental and exempt facility bonds

Accounting for Expenditures
(cont'd.)

Questions

Borrower intends that the grant and its own funds will finance the retail space. How is this allocation made?

- Default under Tax Code
- Expectations in Tax Certificate
- Final allocation

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 2031 and beyond maturities (final maturity of the bond is 2041), but was only able to sell 5% of 2026-29 maturities, and 25% of 2030 maturities.

Issue Price Hypo (cont'd.)

Questions

- How do you determine issue price?
  - All sold vs 5% sold vs 25% sold
  - General rule vs. Hold the offering price
- What assertions must be included in the Bond Purchase Agreement?
- What documentation is needed for issue price purposes?
- Considerations
  - Competitive vs. Negotiated
  - Single underwriter (no selling group or retail distribution) vs. selling group

Questions