BOND ARBITRAGE FUNDAMENTALS

Securities offered through First Allied Securities, CA

Services, Inc.

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What is Arbitrage?

- The simultaneous purchase and sale of an asset in order to profit from a difference in the price.*

- It is a trade that profits by exploiting price differences of identical or similar financial instruments, on different markets or in different forms.*

- Arbitrage exists as a result of market inefficiencies; it provides a mechanism to ensure prices do not deviate substantially from fair value for long periods of time.*

*http://www.investopedia.com/terms/a/arbitrage.asp#axzz2Mn19CKzP

Arbitrage Bonds Defined

- Under § 148(a), an arbitrage bond is, any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bond) to be used, directly or indirectly—
  - (1) to acquire higher yielding investments, or
  - (2) to replace funds which were used directly or indirectly to acquire higher yielding investments.
- For purposes of this subsection, a bond shall be treated as an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the issue of which such bond is a part in a manner described in paragraph (1)or (2).

Source - https://www.irs.gov/pub/irs-wd/0116004.pdf

Federal Arbitrage Rebate

Tax-exempt bonds generally have lower interest rates than taxable bonds. This is because investors are willing to accept a lower interest rate on a bond if they will not be taxed on the interest that they receive.*

For example, a city that is able to issue a tax-exempt bond at 6 percent might need to pay an interest rate of 8 percent if interest on the bond were taxable to the holders. This basic fact is the reason for "arbitrage" rules. Why? Because state and local governments can borrow on the tax-exempt markets, but then turn around and invest on the taxable markets. *

A city that borrows an amount at 6 percent by issuing tax-exempt bonds may be able to invest that amount in taxable securities having an interest rate of 8 percent. In this case the city would be able to make an investment profit of 2 percent because the city itself is, of course, not a taxable entity.*

The arbitrage rules try to keep state and local governments from issuing more bonds than otherwise necessary to take advantage of the investment opportunities, or "arbitrage,"*'

** All content listed in this page sourced from IRS @:* http://www.irs.gov/pub/irs-tege/part2g02.pdf

Bond Proceeds Subject to Arbitrage Regulation

- Bond Sales
- Investments
- Transferred Proceeds
- Replacement Funds

Arbitrage Calculation Parameters

- Conducted every 5th bond year.
- Calculated Installment is payable within 60 days.
- 90% of cumulative rebate amount is due.
- Subject to FINAL CALCULATION upon final maturity
- All bonds have been retired
- 100% of arbitrage rebate due at that time

Exceptions to Rebate

- SPENDING EXCEPTIONS
  - 6 – 18 – 24 Month components
- SMALL ISSUER EXCEPTION
- DEBT SERVICE FUND EXCLUSION

Arbitrage Exceptions

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- CAPITAL PROJECTS

  - Investment proceeds of an issue reasonably expected to be allocated to expenditures for capital projects qualify for a temporary period of three years.

  - During this period, the proceeds and replacement proceeds of the issue may be invested in higher yielding investments without causing bonds in the issue to be arbitrage bonds.

Over-payment of Rebate

- 1. The period of limitations for an issuer of bonds to bring suit to recover an overpayment of an arbitrage rebate paid to the Service is the general six-year period under 28 U.S.C. §§ 2401 and 2501.

- 2. The period of limitations for bringing suit to recover an overpayment of an arbitrage rebate under 28 U.S.C. §§ 2401 and 2501 begins upon payment of the rebate with the submission of Form 8038-T, the arbitrage rebate form. Consequently, any suit brought by Issuer at this time would be untimely, as more than six years have passed since Issuer submitted Form 8038-T and its final arbitrage rebate payment.

Source: https://www.irs.gov/pub/irs-wd/0446021.pdf

Recommended IRS Checklist for Arbitrage Compliance

- Due diligence review at regular intervals.
- Identifying the official or employee responsible for review.
- Training of the responsible official/employee.
- Retention of adequate records to substantiate compliance.
- Procedures reasonably expected to timely identify noncompliance.
- Procedures ensuring that the issuer will take steps to timely correct noncompliance.

Source - nast.org/wp-content/uploads/Post-Issuance Compliance

Recommended IRS Compliance Checklist - 2

- Maintain complete inventory of bonds
- Bond policies and procedures integrated with organizational policies and procedures
- Job descriptions include bond responsibilities
- Creates a bond compliance officer
- Annual certification checklists from key reporters and bond compliance officer (preserved)
- Process in place to alert responsible personnel to changes in requirements Periodic training of personnel responsible for compliance efforts

Source - nast.org/wp-content/uploads/Post-Issuance Compliance

IRS Compliance Audit Scenarios

- Provide all requisitions (cover page only) submitted to trustee for expenditures of bond proceeds for all accounts associated with the bonds from date of creation.
- Account Payable/GL or detail schedule of the cost of the Projects financed with bond proceeds. This schedule should contain the following information: Payees, amounts, date, description, etc…
- Please provide a description of the financed property and its manner of management and operation. Include a listing of the facilities or assets acquired with bond proceeds including the date(s) acquired or placed in service and the total cost of each asset.
- A schedule of the final allocation of bond proceeds.

Source - nast.org/wp-content/uploads/Post-Issuance Compliance

IRS Record Retention Requirements

- Requirements are burdensome and may not be consistent with document destruction policies.
  - Life of the Bonds + 3 years
  - If the Bonds are refunded, life of refunding bonds + 3 years

- Consider separate document collection, storage and destruction policies for bond related records.

- Consider electronic storage systems.

IRS Arbitrage Rebate & Yield Restricted Compliance

- Determine the yield for arbitrage purposes
- Compile and maintain a list of bonds in need of rebate and yield restriction calculations
- Monitor compliance with exceptions
- Identify temporary periods
- Monitor compliance with yield restriction requirements
- Perform calculations no later than 5-year anniversary dates and final maturity dates (may be earlier than 5-years)
- Make payments no later than 60 days after computation date
- Initiate corrective steps if payments are not made timely, or if other violations are identified
- If 501(c)(3) filing IRS Form 990 Schedule K, report date that required rebate calculations were completed

Source - nast.org/wp-content/uploads/Post-Issuance Compliance

Taking a look at:

Potential for reduced borrowing costs

Reinvesting bond proceeds in a timely and prudent manner can:

- Minimize negative carry
- Reduce net borrowing costs

Interest Income Gains

- Increased investment earnings may reduce borrowing costs tied to the bond issue, or increase amounts available to cover greater project costs.

Avoiding Money Market by Default

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- Reserve fund dollars attached to bond issues may be defaulted to Money Market accounts with the trustee, potentially limiting interest-income earnings in todays markets.
- Yearly income that is not captured, represents a significant opportunity cost over the life of the bond issue, in some cases 30+ years.
- City’s Bond Trust Indenture specifies permitted investments for these funds, deemed appropriate by the City’ bond council, as stated in document.
- Opportunities exist here to potentially increase interest income and helps the City alleviate debt service payments.

Putting a strategy together

- There are several things to consider when trying to understand your options:

- Bond Indenture interpretation
- Potential Tax and Rebate implications
- Principal protection is KEY!!! - Permitted Investment Alternatives
- Maturity restrictions, valuation, liquidity

Permitted Investments

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- Defined in bond documents as the guideline to be follow during the structuring, and consequent implementation of, investment strategies for bond related funds.

KEY Considerations

- PRINCIPLE PROTECTION
- LIQUIDITY
- YIELD

CA Treasurer's Office says:

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There are three major classes of financial products available for the investment of bond proceeds:

- Individual securities or a portfolio comprised of such securities
- Investment agreements
- Mutual, or pooled, investment funds, including money market funds

Excerpt taken from: http://www.treasurer.ca.gov/cdiac/debtpubs/primer/chapter11.pdf

QUESTIONS?