

# Welcome to the APFP Arbitrage – It's Baaaack Webinar



# Panelist

**Craig Robinson** (Moderator) – APFP Board of Governors / Senior Vice President – Truist

**Kim Hoyt** – President – Bingham Arbitrage Rebate Services

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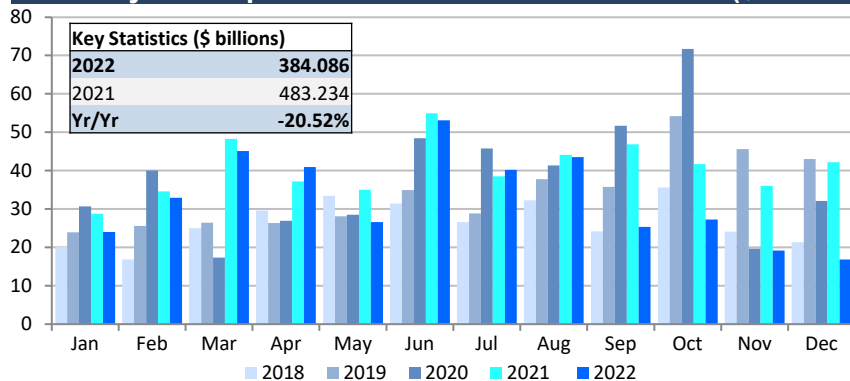
**Leslie Weaber** – Senior Managing Consultant – PFM Asset Management

# CAPITAL MARKETS UPDATE

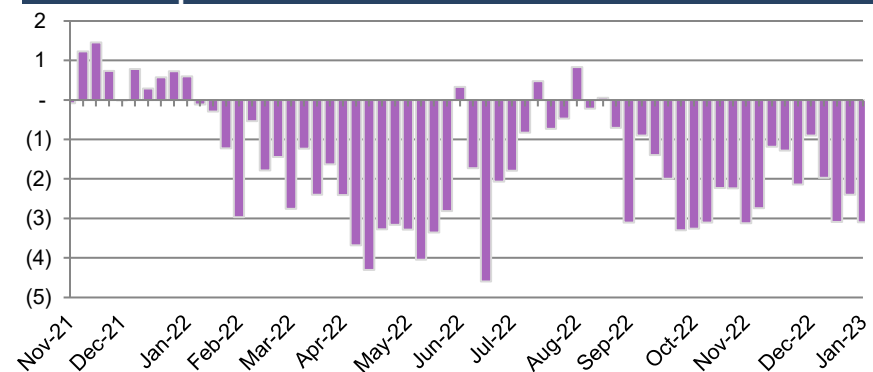
# 2022 Market Conditions and Current Snapshot

- After steady inflows for 2021 (only 1 week of negative flows), 2022 saw over \$120 billion of outflows – the most on record. Only 9 weeks in 2022 saw positive flows.
- Municipal yields jumped in 2022, starting in early January and continuing throughout the year. The 2-Year MMD rose by 236 bps for the year, the 10-Year by 160bps, and the 30-Year by 209bps, well above their 10-year averages.
- Municipal new issue supply decreased by 20% for 2022 (\$383 billion) compared to 2021 (\$483 billion); much of the decline was due to a 56% decrease in taxable issuance. SWS is expecting new issue supply for 2023 to be in the \$350B-\$375B range.
- Inflation concerns dominated the markets in 2022 as both CPI and PPI saw consistently high readings.

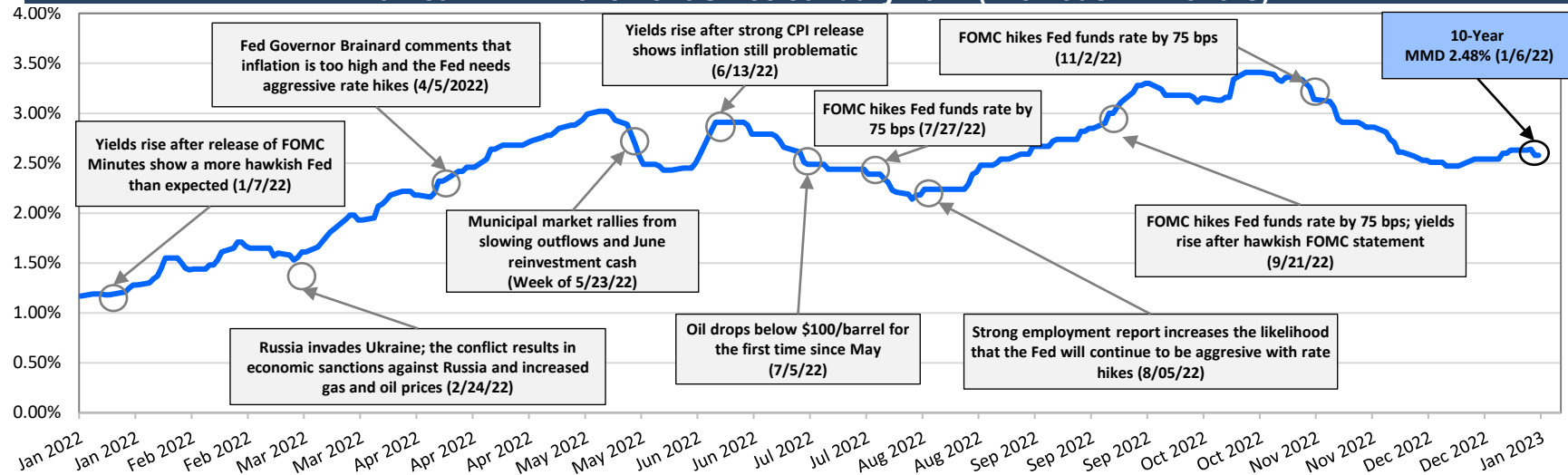
**Monthly Municipal Bond Issuance for 2018 – 2022 (\$ Billions)**



**Municipal Bond Mutual Fund Inflows and Outflows**

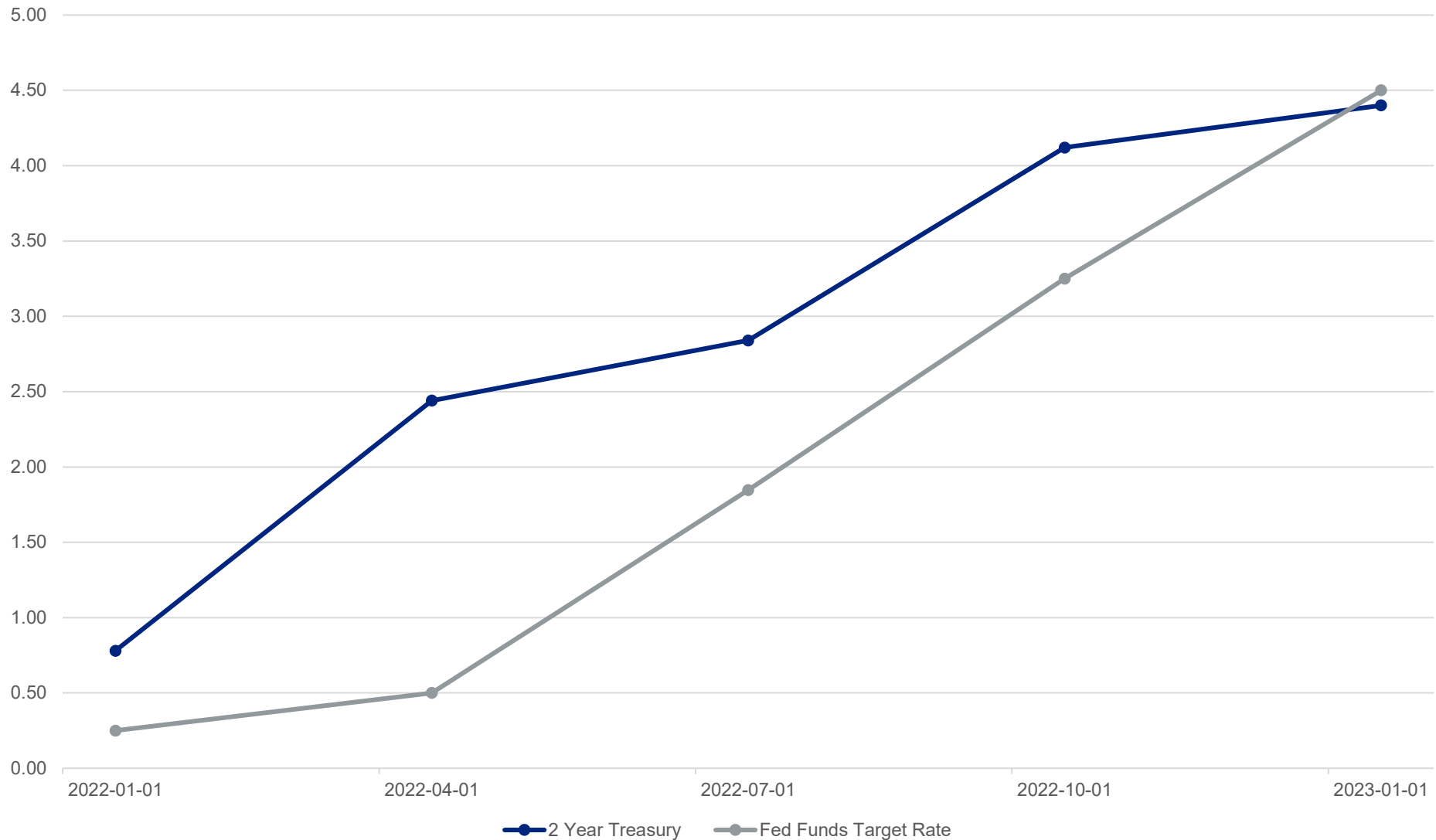


**10-Year MMD Movement Since January 2022 (Previous 12 Months)**



Note: All rates, analyses, and commentary are as January 6, 2023  
 Source: The Bond Buyer; MMD yields provided by TM3, Market commentary provided by SWS

# Rise of 2 Year Treasury & Fed Funds Target Rate



# ARBITRAGE REBATE COMPLIANCE

# Arbitrage Rebate Compliance

Because interest paid to bondholders is excludable from gross income for federal income tax purposes, the bondholders are willing to accept a lower interest rate than they would accept if the interest were taxable.

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To receive this benefit, an issuer must ensure that the applicable requirements of the Internal Revenue Code (the “Code”) are met, both on the date of issuance and generally for as long as the debt remains outstanding.

# Definitions

## Arbitrage

The difference between the interest paid on tax-exempt bonds and the interest earned by investing the proceeds of the tax-exempt bonds in taxable higher yielding securities. Federal income tax laws generally restrict the ability to earn arbitrage in connection with tax-exempt bonds or other federally tax-advantaged bonds.

## Arbitrage Rebate

Investment earnings on your bond proceeds in excess of the declared tax-exempt bond yield must be rebated to the Federal Government.



# What Kind of Debt Requires Arbitrage Rebate and Yield Restriction Calculations?

**Applies to every tax-exempt borrowing and some taxable subsidy obligations**

## **Examples include:**

- Bonds: General Obligation, Revenue, Limited Obligation
- Notes, Leases, Commercial Paper
- Installment Financing Contracts / Agreements
- BABs, QZABs, QSCBs

(Filing any type of IRS Form 8038 means post-issuance compliance for arbitrage rebate and / or yield restriction is required.)

## Two Sets of Rules and Two Separate Calculations

# Arbitrage Rebate & Yield Restriction – It's the Law

### Arbitrage Rebate Rules:

Compliance due at least every 5 years while gross proceeds remain outstanding, and

### Yield Restriction Rules:

If project proceeds are held > 3 years, outstanding project proceeds are to be yield restricted and earn limited income. The yield restriction calculation becomes a factor for compliance purposes.

## Myth Busters

- ❖ “I need to spend all my Construction Proceeds within three years, or I’ll lose my tax-exempt status” – **FALSE**
- ❖ “I should keep my gross proceeds in cash, so I’ll avoid arbitrage earnings” – **FALSE**
- ❖ “If I spend all of my Construction Proceeds within two years, I’ve met the 2-Year Spending Exception” – *Maybe*

# Exceptions

- ❖ Small Issuer Exception
- ❖ Spending Exceptions
  - 6-month spending exception
  - 18-month spending exception
  - Two-Year spending exception
- ❖ “Bona Fide” Debt Service Fund exception

# Spending Exceptions

- **Six-Month Exception:**

- 100% at 6 Months

## **Eighteen-Month Exception:**

- 15% at 6 Months
- 60% at 12 Months
- 100% at 18 Months (5% reasonable retainage)

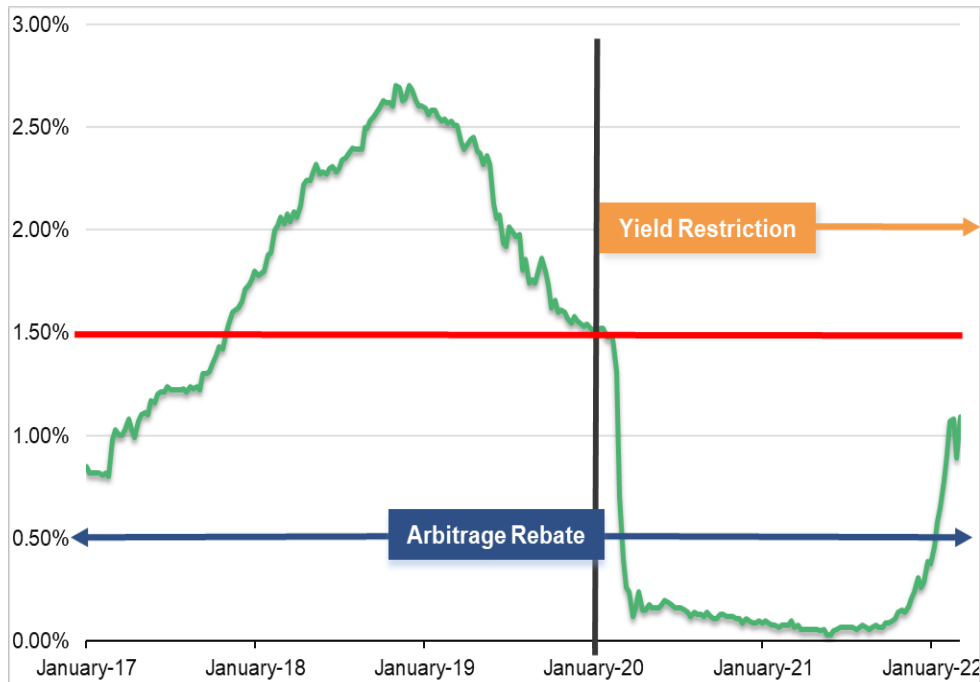
## **Two-Year Construction Exception:**

- 10% at 6 Months
- 45% at 12 Months
- 75% at 18 Months
- 100% at 24 Months (5% reasonable retainage)

## **Funds Subject to Post-Issuance Compliance**

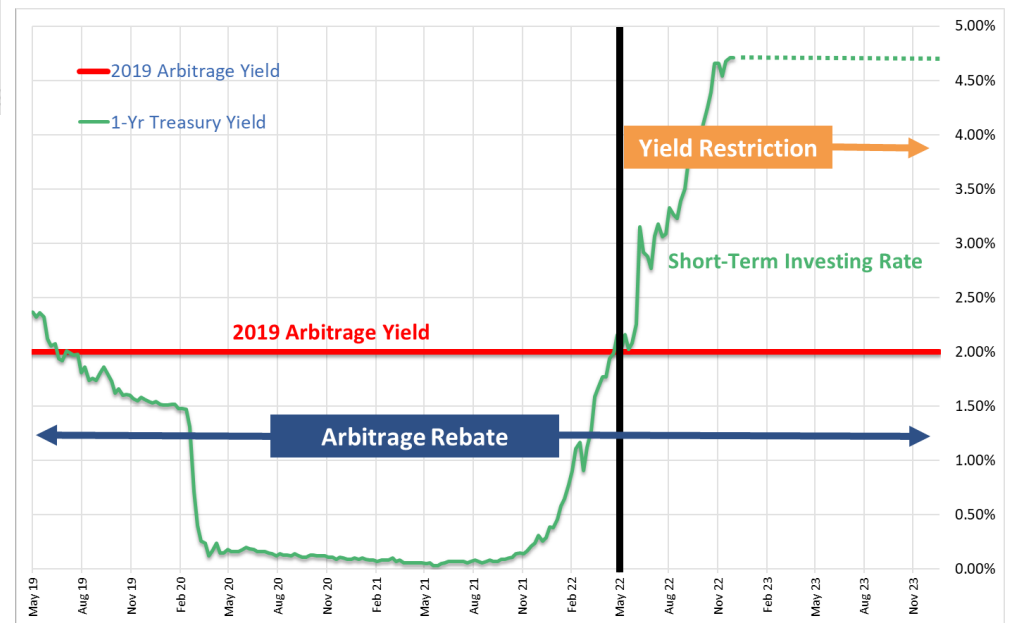
- Cost of Issuance Fund
- Project / Construction Fund
- Capitalized Interest Fund
- Debt Service Reserve Fund
- Escrow Fund
- Sinking Funds
- Interest Earnings
  
- Pledged Funds
  
- Transferred Proceeds

# Arbitrage Rebate versus Yield Restriction



← 5-year period starting in 2017...

Very different from 5-year period starting in 2019... →



# Comparison

## ARBITRAGE REBATE

### Example:

*First Installment Period*  
*(Years 1 - 5)*

Investment Yield:	1.90%
<u>Bond Yield:</u>	<u>2.25%</u>
Arbitrage:	-0.35%

*No Rebate payment due*

## YIELD RESTRICTION

### Example:

*First Installment Period*  
*(Years 4 – 5)*

Investment Yield:	2.50%
<u>Bond Yield + .125%:</u>	<u>2.375%</u>
Earnings over Bond Yield:	.125%

*Yield Reduction payment due*



# Best Practices for Arbitrage Rebate Compliance

- ❖ Check with bond counsel regarding reimbursement resolutions.
- ❖ Have compliance reports completed annually versus waiting until the fifth-year/installment period.

# Best Practices for Arbitrage Rebate Compliance

- ❖ Inform your arbitrage rebate firm of changes to an issue, such as being refunded. Evaluation dates change.
- ❖ Maintain good records by keeping:
  - Bank/Investment/Trust Statements
  - Bond Transcript
  - Past Arbitrage Rebate Reports

IRS requirement: Keep all records for tax-exempt issues at least 3 – 6 years after bonds paid in full.

# **Written Procedures for Arbitrage Rebate Compliance**

## **What is the IRS looking for in Written Procedures?**

1. Documentation
2. Who is in charge of overseeing compliance?
3. Who is responsible for making sure calculations/reports are completed?
4. Will your department complete calculations in house? Or will an outside firm be hired?
5. Use of Proceeds / Change in use
6. Education and Training
7. Record Keeping

# How can arbitrate earnings be a good thing?

- ❖ You earned the most bang for your buck!
- ❖ Your investment return was good.
- ❖ Being prepared when the installment date arrives, no one is caught off guard and everyone is ready when the payment is due.

## Contact Information

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