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Investing Bond Proceeds

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Treasurer, City of Saint Paul, MN

Sunday, June 6, 2010, 3:50 p.m. – 4:40 p.m.
Concurrent Sessions

City of Saint Paul





Investing Bond Proceeds

- Investment Objectives
- Rules and Regulations
- Investment Options
- Bond Fund Types
- Current Market Example

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Investment Objectives

Investment decision is issuer responsibility

Manage Risk

- Credit Risk (safety)
- Market Risk (liquidity)
- Opportunity Risk (yield)

Lower the Cost of Borrowing

- Reduce bond size
- Reduce debt service

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Rules and Regulations

- Bond Documents/Indenture
 - *Permitted Investments*
- State and Local Laws
- Investment Policy
- Rating Agency
- Insurance guidelines
- Federal Laws
- IRS/Arbitrage
 - *Interest Earnings*

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Investment Options

- Mutual or pooled investment funds
 - *Local Government Investment Pool (LGIP), Money Market Funds, Sweet Accounts*

- Certificates of Deposit
 - *Collateralized CD's*

- Individual securities or portfolio of securities
 - *Treasuries, Agencies, SLGS, laddered investments*

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Investment Options

➤ Structured Investment Agreements

- Guaranteed Investment Contract (GIC)
 - *Fixed rate investment based on draw down*
 - *Credit risk based on provider*
 - *Negotiated collateral on down grade*
 - *Fair Market Value at Par*
 - *Limited providers in current market*
- Collateralized Repurchase Agreement
 - *Collateralized at inception*
 - *Lower investment yield (40 bps in today's market)*

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Investment Alternative features

	Safety	Liquidity	Yield
GIC	GICs are typically issued by highly rated (AA or better) investment providers. Downgrade provisions requiring collateral provide protections to the issuer. <u>Recent events have increased risk.</u>	GICs are structured with a high degree of flexibility in the withdrawal of funds, with minimal advance notice (typically 1 day).	GICs should provide the highest fixed yield among the investment options for bond proceeds.
Repurchase Agreements	Repos are collateralized with securities authorized (typically U.S. treasuries or agencies) by the debt issuer. A third-party custodian holds the collateral on behalf of the issuer.	Repos are structured with a high degree of flexibility in the withdrawal of funds, with minimal advance notice (typically 1 day).	Repos will provide a yield below GICs. Repo yields will be approximately equal to a laddered portfolio with an equivalent average life.
Security Portfolio	A security portfolio that meets the investment policies (typically U.S. treasuries or agencies) of the issuer. A third-party custodian holds the collateral.	A laddered security portfolio is designed to meet the issuer's cash flow needs. The issuer may be subject to reinvestment risk or capital losses if cash is required on a schedule that differs from the security maturity schedule.	The yield for a security portfolio will be comparable to a repo with an equivalent average life.
Bank CD	The first \$250,000 is insured by the FDIC. Amounts greater than \$250,000 should be collateralized.	Like a security portfolio, a laddered CD portfolio will have limited flexibility. Often CDs have redemption penalties if sold prior to maturity.	The yield on Bank CDs varies widely depending on the bank. The yield for a laddered CD will be similar to a repo.
LGIP's and MM Funds	Use only LGIPs and MM Funds rated AAAM by Standard & Poor's. Assets are protected with pooled collateral.	These funds have a high degree of liquidity. Funds can be withdrawn with minimal advance notice (1 day).	The funds provide a variable yield that can change on a daily basis.



Bond Fund Types

- Construction/Project Fund
 - *Planning, Acquisition, Construction*
 - *Generally 6 months to 3 years*
 - *Based on draw schedule*
 - *Interest earnings used for project expense or capitalized interest*
- Capitalized Interest Fund
 - *Used to pay debt service during construction period*
 - *Generally 6 months to 3 years*
 - *Based on debt schedule*
- Debt Service Reserve Fund
 - *Sized at lesser of 10% bond issue or maximum annual debt service*
 - *Used in the event of debt service payment shortfall*
 - *Longer term investment*
 - *Interest earnings used to offset debt service expense*

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Current Market Rates

MONEY CENTER RATE SUMMARY

ALL RATES SUBJECT TO MARKET CONDITIONS

Investment	1 day	7 day	14 day	30 day	45 day	60 day	90 day	120 Day	180 Day	270 Day	1 Year	18 Mo	2 Year	5 Year
Commercial Paper	0.13%	0.16%	0.16%	0.21%	0.23%	0.26%	0.32%	0.32%	0.39%	0.44%	N/A	N/A	N/A	N/A
Certificate of Deposit	N/A	0.00%	0.00%	0.00%	0.00%	0.03%	0.09%	0.09%	0.17%	0.22%	0.32%	0.58%	0.93%	2.59%
Repurchase Agreement	0.00%	0.00%	0.00%	0.00%	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Bankers' Acceptances- average rates	N/A	N/A	N/A	0.19%	0.26%	0.33%	0.37%	0.42%	0.57%	N/A	N/A	N/A	N/A	N/A
Treasury Bills/Notes/Bonds	N/A	0.02%	0.04%	0.05%	0.07%	0.08%	0.10%	0.13%	0.17%	0.25%	0.35%	0.64%	0.84%	2.21%
Agency Discount Notes	0.03%	0.02%	0.12%	0.07%	0.05%	0.05%	0.08%	0.11%	0.21%	0.22%	0.41%	N/A	N/A	N/A
Agency Non-Callable Bonds	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	0.40%	0.60%	0.87%	2.40%

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Current Market Rates

As of May 10, 2010

CASH AND SWAP INDICATIONS

Years	Treasury	GO AAA	Investment Agreement	Repurchase Agreement
1	0.38%	0.40%	0.74%	0.34%
2	0.81%	0.71%	1.21%	0.81%
3	1.32%	1.06%	1.71%	1.31%
4	1.79%	1.43%	2.18%	1.78%
5	2.16%	1.81%	2.58%	2.18%
7	2.86%	2.47%	3.16%	2.76%
10	3.43%	3.13%	3.64%	3.24%
15	4.00%	3.79%	4.03%	3.63%
20	4.15%	4.05%	4.17%	3.77%
30	4.27%	4.40%	4.29%	3.89%

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Current Market – Bond Example

Effective Investing will:

- Reduce bond issue size
 - *Smaller capitalized interest deposit*
 - *Smaller deposit to debt service reserve fund*
- Reduce average debt services
 - *Smaller bond size*
 - *Larger credit from DSRF investment*

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Current Market – Bond Example

Project: Community Event Facility

Bond Type: Revenue Bond

Rating: AA

Cost: \$40 million

Revenues Generated: Upon project completion

Construction Period: Two years

Capitalized Interest Period: Two years

Term: 25 years

Debt Service Reserve Fund: Required

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Current Market – Bond Example

<u>Sources</u>	<u>Current Market</u>	<u>“Normal Interest” Market</u>	<u>Variance</u>
Bonds	\$49 Million	\$46 Million	<\$3 Million>
<u>Uses</u>			
Project Fund	\$40 Million	\$40 Million	---
Capitalized Interest Fund	\$4.8 Million	\$2.1 Million	<\$2.7 Million>
Debt Service Reserve Fund	\$3.6 Million	\$3.3 Million	<\$300,000>
<u>Investments</u>			
Project Fund	0.25% LGIP	5.25% Repo	<5%>
Capitalized Interest Fund	0.25% LGIP	5.25% Repo	<5%>
Debt Service Reserve Fund	3.00% Agency	5.25% Repo	<2.25%>
Average Annual Net D/S	\$3,460,000	\$3,160,000	<\$300,000>
Effective Interest Cost	4.95%	4.74%	<0.21%> City of Saint Paul





Closing

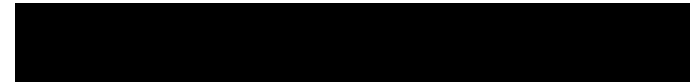
- Develop your investment strategy early
- Investing is the issuer responsibility
- Focus on safety, liquidity, yield
- Use Due Diligence
 - *Understand what you are buying*
 - *Make sure your fees are reasonable*
 - *Insure fair market value on securities*
 - *Establish ongoing monitoring*
- Earn some positive arbitrage-make sure to rebate it

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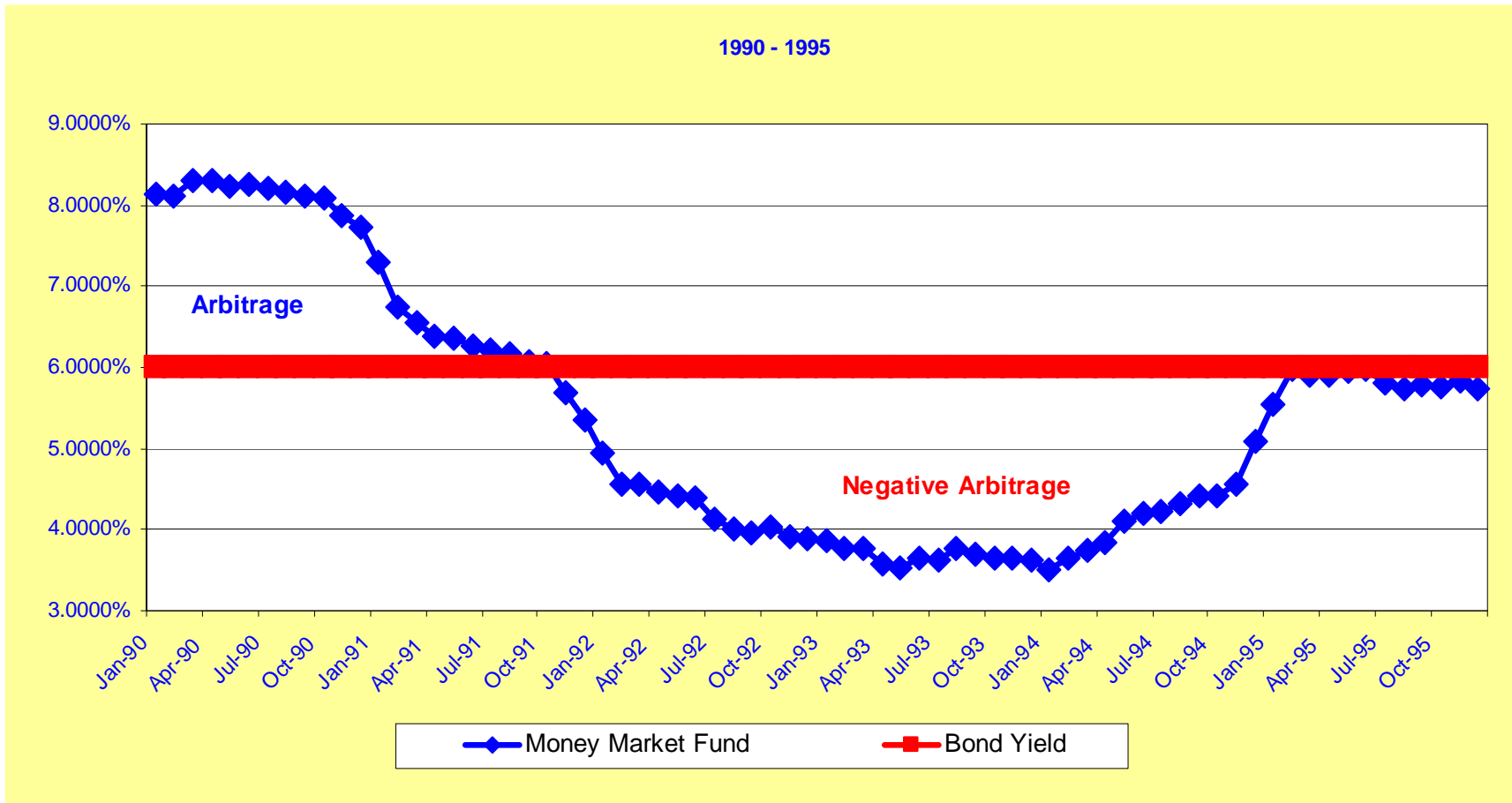


Arbitrage Rebate and Yield Restriction Compliance





Arbitrage Rebate from 1990-1995





Goal of IRS Arbitrage Rules

Eliminate any arbitrage incentive to:

- Issue more bonds than needed,
- Issue bonds earlier than needed, and
- Leave bonds outstanding longer than needed

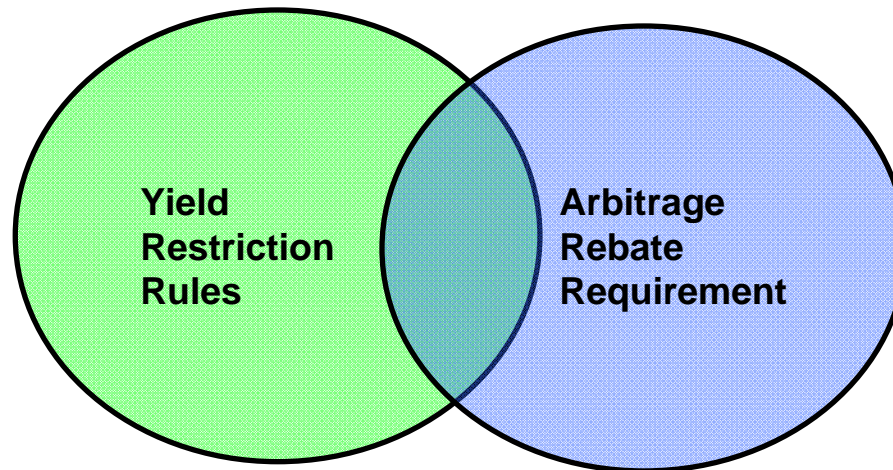
to accomplish the governmental purpose of the bond issue.



Two Separate Rules

Yield Restriction – IRC Section 148(a): Governs when you may legally earn arbitrage from investing bond proceeds.

Arbitrage Rebate - IRC Section 148(f): Mandates when you must rebate arbitrage earned to the federal government.



Prior to 1986, only yield restriction applied. After 1986, both rules apply to a bond issue.



History of the Arbitrage Laws

First major arbitrage laws passed as part of the Tax Reform Act of 1969.

- Imposed limited time periods (“temporary periods”) for earning arbitrage.

First arbitrage regulations issued in 1979.

- Most of those restrictions still apply today.

Arbitrage Rebate requirement first imposed to issuers in the 1980’s.



Proceeds Subject to Yield Restriction



Capital Project Funds

– Balance remaining after three-year “temporary” period.



Reserve Funds

- Only amount in excess of “Reasonably Required” reserve.



Advance Refunding Escrow Funds

– Yield restricted from date of issue.



Debt Service Funds

– 13 months if not used.



Yield Restriction Rules - Temporary Periods

Yield restriction rules preceded rebate requirements.

Temporary periods are time periods in which investing proceeds at a materially higher yield will not cause the bonds to become “arbitrage” bonds.

Yield restriction is determined over time, not by investment.

When determining compliance with yield restriction, all yield restricted (same “class”) are blended together.

- Lowest available materially higher yield is used for two types of restricted money.
- Sample: Construction fund (after 3 years) and escrow fund, use 1/1000th of 1% limit.



Yield Restriction Rules - After the Temporary Period

Yield restrict remaining proceeds; or

Yield reduction payment may be permitted under 1993 Regulations

Yield Reduction Payments:

- 1993 regulations administrative solution to yield restriction.
- Yield Reduction Payments (YRPs) are payments made to the IRS on yield restricted funds.
- Paid at same time and manner as a rebate payment.



Yield Reduction Payment Sample

		Arbitrage Earned
Years 1-3	(Unrestricted)	<90,000>
Years 4 & 5	(Restricted)	70,000
Arbitrage Rebate Payment		-0-
Yield Reduction Payment		70,000



Proceeds Subject to Arbitrage Rebate



Sales proceeds

– Received from the sale of the bonds.



Investment proceeds

- Interest earnings on proceeds of an issue.



Transferred proceeds

– Unexpended proceeds of a refunded issue.



Replacement proceeds

– Non-proceeds treated as proceeds (e.g., debt service).



Required Arbitrage Rebate Calculation Dates

Installment Calculation Dates (Every 5 Years)

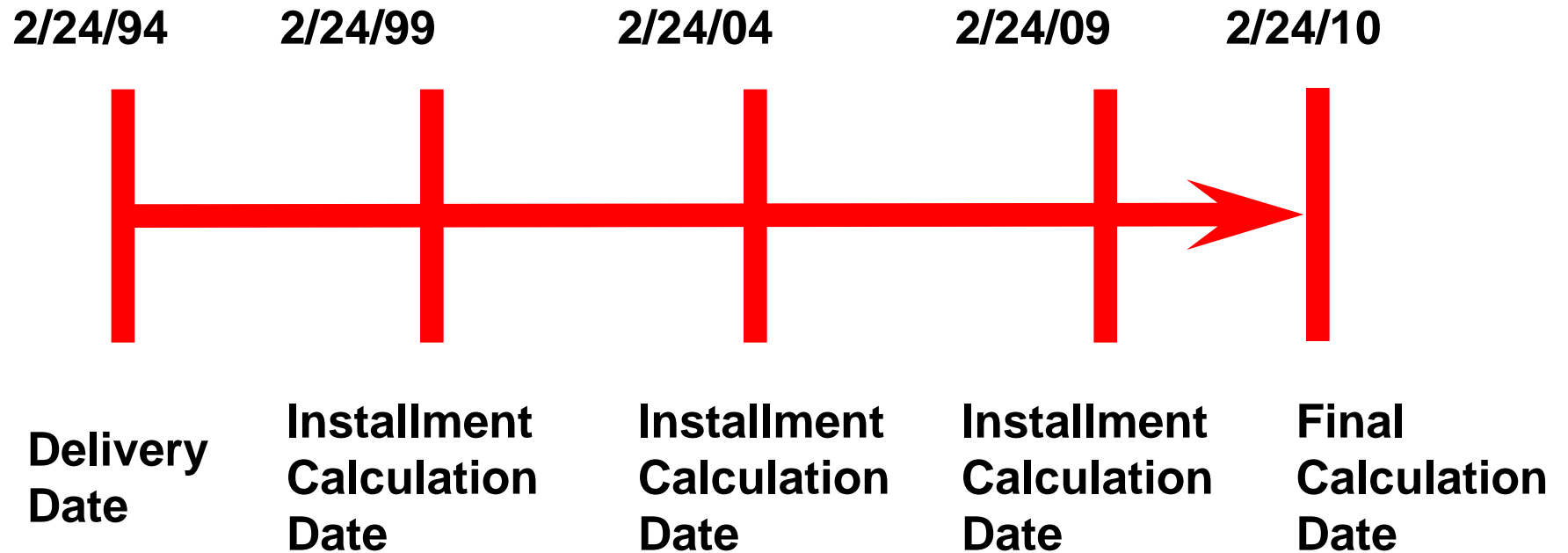
- Installments must be paid at least every 5th bond year.
- Bond year is each one-year period ending on the date selected by the Issuer.
- If no date is selected by the Issuer, bond year ends on each anniversary date of the issue.
- Installment payable within 60 days.
- Installment of at least 90% of cumulative rebate is due.

Final Calculation Date:

- Date all bonds of an issue have been retired
- Cash defeasance or refunding may accelerate final computation date.
- Final payment due within 60 days.
- 100% of remaining arbitrage rebate amount is due.



Sample Arbitrage Reporting Dates





Exceptions to the Rebate Requirements

- **Small Issuer Exception**
 - \$5 million or less in total T/E debt sold in calendar year
 - Up to \$15 million for construction of public school facilities
- **Debt Service Fund Exclusion**
 - Balance Test – less than 1/12th of debt service as a low balance
 - Earnings Test – less than \$100,000 per bond year for non-governmental
- **Spending Exceptions:**
 - ❖ 6-Month Exception
 - ❖ 18-Month Exception
 - ❖ 24-Month Exception



18-Month Spending Exception

Period	Cumulative Expenditures
6 months	15 %
12 months	60 %
18 months	100 %

Exception fails if any semi-annual period is missed.



24-Month Spending Exception

Period	Cumulative Expenditures
6 months	10 %
12 months	45 %
18 months	75 %
24 months	100 %

Exception fails if any semi-annual period is missed.



Small issuers subject to Yield Restriction!

Remember, the small issuer exception exempts an issue or issues from the arbitrage rebate requirements.

However, the issue must still meet the yield restriction requirements!



Investment vs. Disbursement Method of Calculating Rebate

Excerpt from IRS 2010 Work Plan:

“... TEB will also review the use of the “disbursement method” of calculating rebate in instances where proceeds of maturing investments are allowed to remain idle rather than immediately reinvested.”

- There are two dominate methods to compute the arbitrage rebate amount: the “Investment Method” or the “Disbursement Method.”
- The Investment Method tracks each individual investment made with proceeds of the bond issue. If an investment matures and is not reinvested, it is uninvested cash and excluded it from the calculation. Under the Disbursement Method, only interest earned and disbursements are tracked – not specific investments. It is assumed that proceeds are always invested until expended.
- The difference is that uninvested cash is treated as “invested” at 0% under the Disbursement Method, which can artificially lower the arbitrage rebate amount. An issuer could manipulate (lower) the arbitrage liability by leaving balances uninvested and generating negative arbitrage equal to the difference between the bond yield on the issue and zero. This does not happen under the Investment Method.
- Prior arbitrage regulations (Section 1.103) specifically stated that “cash is not a zero percent investment.” Current regulations are silent to treatment of uninvested cash.



Sample Disbursement Method Rebate Calculation

http://reporting/ReportViewer.aspx?ReportFile=Fixed%20Comb%20Cashflows%20with%20Rebate.rpt&View - Microsoft Internet Explorer

Save a Copy Print Search Select 150% Sign

Methodology Investment

COMPUTATION OF THE REBATE AMOUNT

Transaction Date	Includable Principal	Includable Interest	Includable Total	Future Value Factor	Future Value 04/05/2011 3.250000%
04/05/2010	(5,000,000.00)	0.00	(5,000,000.00)	1.0327641	(5,163,820.31)
04/16/2010	(7,500.00)	7,500.00	0.00	1.0317472	0.00
05/15/2010	5,007,500.00	20,000.00	5,027,500.00	1.0290712	5,173,655.62
	\$0.00	\$27,500.00	\$27,500.00		\$9,835.31
			\$27,500.00		\$9,835.31 REBATE AMOUNT

8.50 x 11.00 in 1 of 1 Unknown Zone



Sample Investment Method Rebate Calculation

http://reporting/ReportViewer.aspx?ReportFile=Fixed%20Comb%20Cashflows%20with%20Rebate.rpt&View - Microsoft Internet Explorer

Save a Copy Search Select 150% Sign

Methodology Investment

COMPUTATION OF THE REBATE AMOUNT

Transaction Date	Includable Principal	Includable Interest	Includable Total	Future Value Factor	Future Value 04/05/2011 3.250000%
04/05/2010	(5,000,000.00)	0.00	(5,000,000.00)	1.0327641	(5,163,820.31)
04/16/2010	5,000,000.00	7,500.00	5,007,500.00	1.0317472	5,166,474.18
04/20/2010	(5,007,500.00)	0.00	(5,007,500.00)	1.0313777	(5,164,623.84)
05/15/2010	5,007,500.00	20,000.00	5,027,500.00	1.0290712	5,173,655.62
	\$0.00	\$27,500.00	\$27,500.00		\$11,685.65
			\$27,500.00		\$11,685.65 REBATE AMOUNT

8.50 x 11.00 in 1 of 1 Unknown Zone



Payments to the IRS

- Make check payable to United States Treasury Department.
- Complete Form 8038-T.
- Mail Rebate Payments to IRS Center in Ogden, UT.
- Form 8038-T only filed when rebate amount is positive, under current law.



Build America Bonds and Tax Credit Bonds



Build America Bonds

Created by the American Recovery and Reinvestment Tax Act of 2009 (ARRA):

- BABs are taxable to the bondholder (investor), but tax-exempt to the issuer.
- Three types of BABs:
 - Tax Credit BABs – bondholder receives a 35% tax credit
 - Direct Pay BABs – issuer receives a 35% interest payment
 - Recovery Zone Economic Development Bonds
- BABs must qualify as a governmental bond, not a private activity bond.
- Tax Credit BABs may be used to finance capital expenditures, working capital, current refundings, or one advanced refunding. Direct Pay BABs may be used to finance capital expenditures on projects, and cannot be used for refundings.
- BABs are subject to the arbitrage rebate and yield restriction requirements!!!



Build America Bonds – De Minimis Amount

BABs may be issued at par plus a “de minimis” amount of premium.

- De Minimis Amount of Premium cannot exceed:
 - An amount not greater than 0.25% ($\frac{1}{4}$ of 1 percent) of the stated redemption price of the bond at maturity or its first optional redemption date for the bonds (whichever produces a lower yield)
 - For a bond with a maturity of 10 years or more, de minimis premium is usually not greater than 2.5%.
 - IRS intends to examine de minimis premium amount on BABs.
- De Minimis Amount application for BABs has created uncertainty for the industry
 - IRS Direct Pay Compliance Check Questionnaire asks issuers if they have reviewed trading activity between sale date & delivery date of the bonds to verify they were sold at a de minimis amount of premium.
 - Current rule is at least 10% of each maturity are sold at the issuer price to public.



Build America Bonds – Compliance Requirements

Build America Bonds are subject to the arbitrage compliance requirements:

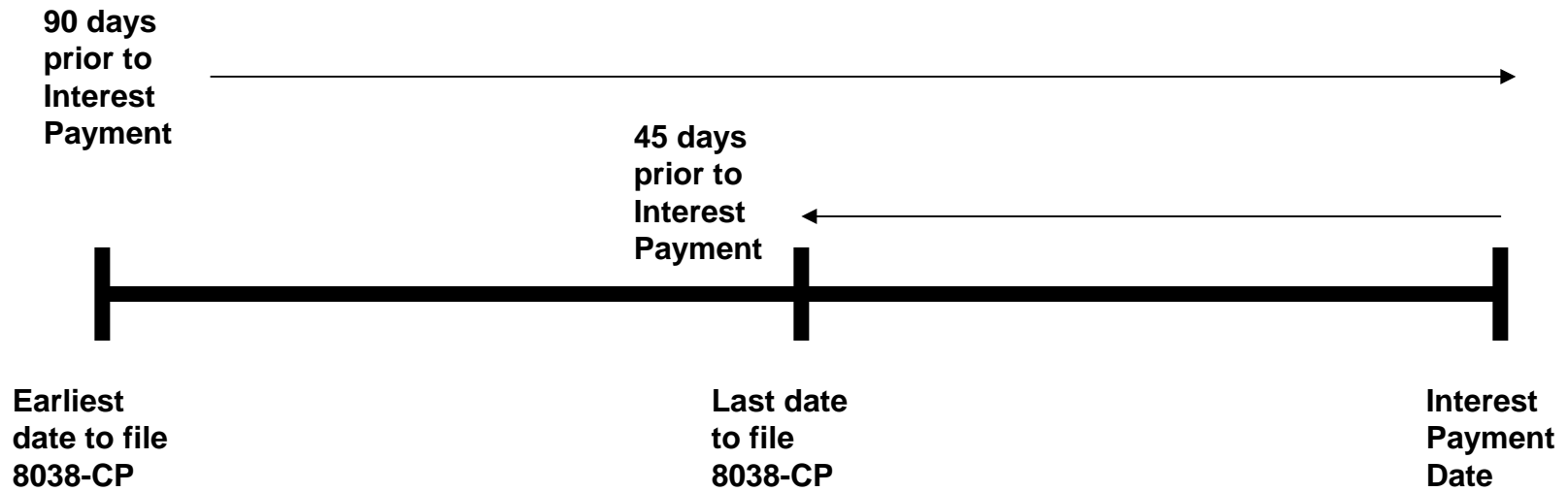
- Since BABs are tax-exempt to the issuer, all of the Section 148 arbitrage rules apply.
- The yield on an issue of BABs is computed net of the 35% subsidy payment, resulting in a lower bond yield.
- Other arbitrage requirements the same as conventional tax-exempt bonds.

Filing and Reporting Requirements:

- Issuer must file Form 8038-B [*Information Return for Build America Bonds and Recovery Zone Economic Development Bonds*] when the bonds are issued.
- Issuers must file Form 8038-CP [*Return for Credit Payment to Issuers of Qualified Bonds*] each time an interest payment is made. Revised in January 2010 for direct deposit.
- Issuers must file Form 8038-T [*Arbitrage Rebate, Yield Restriction and Penalty in Lieu of Arbitrage Rebate*] each five years and upon final redemption of the bonds, is a payment is due.



Timing for Filing Form 8038-CP





Other Tax Credit Bonds

Hiring Incentives to Restore Employment Act (HIRE) of 2010 :

- HIRE Act was signed into law on 3/18/10.
- Expands the types of issues that can receive direct payment subsidy from the Treasury Department.
- A new Form 8038-TC (expected by 6/25/10) being created to report issuance of tax credit bonds.

Tax credit bonds include:

- Qualified School Construction Bonds (QSCBs)
- Qualified Zone Academy Bonds (QZABs)
- Clean Renewable Energy Bonds (CREBs)
- Qualified Energy Conservation Bonds (QECBs)



Tax Credit Bonds under HIRE Act of 2010

Amount of Refundable Credit Available:

- 100% of interest for Qualified School Construction Bonds (QSCBs)
- 100% of interest for Qualified Zone Academy Bonds (QZABs)
- 70% of interest for Clean Renewable Energy Bonds (CREBs)
- 70% of interest for Qualified Energy Conservation Bonds (QECBs)

Form 8038-CP should be used for requesting subsidy (form will be revised). First allowable payment not until September 1, 2010.

Calculation of Refundable Credit Amount:

- Lesser of:
 - (1) Interest payable under the bond on such date, or
 - (2) Interest that would be payable under the bond on such date if the interest were determined at the applicable tax credit rate determined on sale date (using www.treasurydirect.gov).

INTEREST RATES AND PRICES

- ▶ Federal Investments Program Rates and Prices
- ▶ SLGS Rates
- ▼ **IRS Tax Credit Bonds Rates**
 - ▼ QTCB
 - ▶ QZAB
 - ▶ CREB
 - ▶ MWTC
 - ▶ GTC
- ▶ Treasury's Certified Interest Rates
- ▶ Public Debt
- ▶ UTF Quarterly Yields

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Qualified Tax Credit Bond Rates

Important message:
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Related Links

- ▶ [SLGS Reports](#)
- ▶ [SLGS](#)
- ▶ [FAQ](#)

Section 54A of the Internal Revenue Code (IRC) provides rules for the issuance and use of qualified tax credit bonds including new clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy bonds, and qualified school construction bonds. For rates on clean renewable energy bonds issued under Section 54 of the IRC, check our [CREB page](#).

QTCB Historical Rates from April 15, 2010 to April 29, 2010

Date	Rate	Maturity	PSFY*
Apr 15, 2010	5.84%	17 years	4.30%
Apr 16, 2010	5.82%	17 years	4.30%
Apr 19, 2010	5.76%	17 years	4.30%
Apr 20, 2010	5.80%	17 years	4.30%
Apr 21, 2010	5.78%	17 years	4.30%
Apr 22, 2010	5.72%	17 years	4.30%
Apr 23, 2010	5.75%	17 years	4.30%
Apr 26, 2010	5.70%	17 years	4.30%
Apr 27, 2010	5.70%	17 years	4.30%
Apr 28, 2010	5.59%	17 years	4.30%
Apr 29, 2010	5.66%	17 years	4.30%

*Permitted Sinking Fund Yield - The maximum permitted yield for the sinking fund expected to be used to repay the issue under section 54A(d)(4)(C) of the IRC. The permitted sinking fund yield is equal to 110% of the long-term adjusted applicable federal rate (AFR), compounded semiannually. The permitted sinking fund yield is updated monthly.



Tax Credit Bonds – Compliance Requirements

Special arbitrage rules apply to certain Tax Credit Bonds:

- Special rules for Qualified School Construction Bonds and Qualified Zone Academy Bonds:
 - Project funds are not subject to arbitrage rebate or yield restriction during the first three years of the issue.
 - Available project proceeds must be spent within three years to qualify as a tax credit bond.
 - Unspent proceeds at the end of year three must be used within 90 days to redeem bonds.



Tax Credit Bonds – Compliance Requirements

Special “Sinking Fund” rules:

- Amounts invested in a sinking fund are not subject to arbitrage rebate or yield restriction to the extent:
 - Funded at a rate not more rapid than equal annual installments,
 - Funded in a manner reasonably expected to result in an amount not greater than the amount necessary to repay the issue, and
 - The yield on the sinking fund cannot be greater than the average annual interest rate of tax-exempt obligations having a term of ten years or more that are issued during the month the qualified school construction bonds are issued.
- Sinking fund rule applies to all four types of Tax Credit Bonds.
- Yield restriction rate for sinking funds available at www.treasurydirect.gov.



IRS Enforcement Efforts in 2010



IRS Audit Results in 2009

- IRS issued a Governmental Bond Compliance Check Questionnaire (Form 14002) in the Spring 2009 and used it to perform correspondence audits of over 200 governmental entities that issued tax-exempt bonds.
- Questionnaire focused on whether issuer had written procedures for compliance.
- 2009 Audit Results:
 - In 2009 IRS completed 581 tax-exempt bond audits,
 - In late 2009, a grand jury indicted officials of a financial products firm of rigging bids on guaranteed investment contracts.
- IRS has assigned one senior specialist to assist U.S. Justice Department on examining external bond participants (underwriters, investment advisors, attorneys)
- 42 additional hires were made by the IRS in 2009, bringing the total tax-exempt bond specialists to over 100 employees.



IRS 2010 Work Plan

2010 IRS Work Plan includes:

- An estimated 1,200 audits.
- Over 40 compliance checks expected. Compliance checks are not audits, but require issuers to complete a questionnaire about their compliance practices.
- Section 6700 promoter violations (promoters of bad deals)
- SWAP transactions - fees
- SEC & IRS agreed to work more closely together to regulate tax-exempt bonds. Will create a formal committee to discuss issues and market trends.
- The IRS has stated that all Build America Bond issuers will receive a compliance checklist questionnaire.



Questions?

