



BEST PRACTICE

Investment of Bond Proceeds (1996 and 2007) (DEBT and TIM)

Background. When governments issue bonds they deposit proceeds or other monies in various accounts, which may include a construction fund, debt service fund, capitalized interest fund, debt service reserve, or an escrow fund in a refunding. Monies allocated to these funds are invested until needed. The investment strategy for each fund will depend, in part, on federal or state statutes and regulations governing the types of instruments permitted to be used, the yield permitted for the fund, requirements from rating agencies and/or credit enhancement providers, and the anticipated drawdown of bond proceeds. Additionally, each of these funds will have different investment objectives, so there are many factors to be considered by the issuer when selecting an investment instrument.

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local government issuers develop an understanding of the risks inherent in investing bond proceeds and incorporate steps in their investment strategy for each fund to minimize these risks. Three types of risk are: (1) credit risk (*safety*), the risk of investing in instruments that may default; (2) market risk (*liquidity*), the risk of selling an investment prior to maturity or at less than book value; and (3) opportunity risk (*yield/return*), the risk of investing long term and having rates rise or investing short term and having rates fall.

Issuers should consider actions to mitigate these risks. These include establishing guidelines for permitted investments to reduce credit risk, developing good cash flow estimates to reduce market risk, and integrating knowledge of prevailing and expected future market conditions with cash flow requirements to reduce opportunity risk. As with investment decisions made with other public funds, the balance is weighted heavily towards avoiding risk; accordingly safety first, liquidity second, and yield third.

Provided that the maximum arbitrage yield can be earned, state and local government series securities (SLGS) are the preferred investment option rather than open market securities for escrows for refunding bonds. The benefits of SLGS include better matching of settlement dates and fewer arbitrage rebate issues for borrowers.

GFOA also recommends that governments develop specific policies and procedures for the investment of bond proceeds to ensure that legal and regulatory requirements are met, fair market value bids are received, and issuer objectives for various uses of proceeds are attained. Investment of bond proceeds should include an evaluation of investment alternatives including: (1) individual securities or portfolio of securities; (2) investment agreements; and (3) mutual or pooled investment funds, including money market funds. The following actions are recommended as part of the evaluation of investment alternatives:

1. A government should have an investment policy which is disclosed and summarized in the official statement that includes the investment of bond proceeds or describes other documents which outline the parameters for investment of bond proceeds.
2. The government should have procedures in place to ensure timely coordination of its debt management and investment activities.
3. The duties of the individual designated by the issuer to be responsible for the investment of bond proceeds (the "Investment Officer") should be specified and include:

- Working with the financial advisor, bond counsel, and underwriter to determine how bond proceeds will be invested given expectations for the drawdown of proceeds, federal tax law requirements, or other concerns;
 - Ensuring that fees paid to investment brokers are reasonable and are within federal guidelines;
 - Regular and ongoing monitoring investment and custody of bond proceeds;
 - Reinvestment of bond proceeds when necessary;
 - Understanding federal tax law, particularly as it pertains to arbitrage restrictions; and
 - Maintaining adequate records to comply with arbitrage rebate requirements.
4. The Investment Officer must ensure that investment decisions conform to all legal, statutory, and regulatory requirements, all requirements established by the trust indenture/fiscal agent agreement/bond resolution, and all requirements that might be imposed by rating agencies and/or credit enhancement providers, including:
- Establishment of funds and accounts;
 - Designation of eligible investment instruments;
 - Purchase of investments at fair market price;
 - Permitted yields, such as those to comply with federal arbitrage requirements; and
 - Monitoring of arbitrage rebate liabilities and establishment of procedures to reserve liabilities for future remittance to IRS.
5. An issuer should require that underwriters and financial advisors report to them on any finder's fees or fee-sharing arrangements. In addition, the issuer should carefully evaluate any conflicts of interest that may arise from having underwriters or financial advisors who are involved in the sale of bonds also charged with the investment of bond proceeds. As a general matter, there should be no fee sharing or finder's fee arrangement. If in fact these arrangements occur, issuers should require that underwriters or financial advisors report this information to them in advance of any such arrangement.
6. An issuer should seek competitive bids and, where required, a minimum of three bids. Additionally, an issuer should require that all fees associated with investments be fully disclosed to ensure that investments are being purchased at a fair market price. Underwriters of the bonds or the financial advisor may bid to invest the proceeds, but issuers should be sure they are getting a fair market price on the investments. In many cases, the IRS requires three bids from parties not related to the transaction. Sufficient records should be maintained to document that investments were purchased at a fair market price.
7. Extreme care and due diligence should be taken to guarantee that the interests of the issuer are represented if outside professionals are used to solicit and evaluate bids. This is generally best accomplished through the use of competitive request for proposal processes to select the necessary outside financial professionals.

References

- "Making Arbitrage Rebate Calculations an Illustration," *Government Finance Review*, GFOA, October 1991.
- *Guide to Arbitrage Requirements for Governmental Bond Issues and 1994 Supplement*, Terry Burke, GFOA, 1992 and 1994.
- *ABC's of Arbitrage: Tax Rules for Investment of Bond Proceeds by Municipalities*, Frederic L. Ballard, Jr., American Bar Association, 2002.

Approved by the GFOA's Executive Board on March 2, 2007.