

VGFOA Virginia Government Finance Officers' Association
Developing Governmental and Financial Leaders

Everything a Finance Officer Needs to Know About Investing Bond Proceeds

PFM PFM Asset Management LLC

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VGFOA Investment Responsibility

- Treasurer for most counties, cities, and towns
- CFO, Finance Director, or Investment Manager for some municipalities, authorities, and universities
- Trustees assume responsibility for some revenue issues
- Some conduit issuers have specific requirements

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graph TD
    Issuer[Issuer] -- "$" --> Trustee[Trustee]
    Trustee -- "$" --> Investment[Investment]
    Trustee -.-> ID[Investment Decisions]
  
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VGFOA Permitted Investments - Abridged

2.2-4500 Legal Investments (sinking funds)

- Stocks, bonds, notes, etc. of the Commonwealth and its political subdivisions
- Bonds, notes, and other obligations of the United States
- Bonds, notes, and other obligations of Federal Agencies
- Savings account and time deposits in approved banks

2.2-4501 Legal Investments (other public funds)

- Stocks, bonds, notes, etc. of the Commonwealth and its political subdivisions
- Stocks, bonds, notes, etc. of any state of the United States and its political subdivisions

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VGFOA Permitted Investments - Abridged

2.2-4501 Legal Investments (continued)

- Bonds, notes, and other obligations of the United States
- Bonds, notes, and other obligations of Federal Agencies

2.2-4502 – “Prime-quality” commercial paper

2.2-4504 – Bankers acceptances

2.2-4507 – Overnight, term, and open repurchase agreements

2.2-4508 – Registered open-end mutual funds

2.2-4509 – Negotiable certificates of deposit and bank deposit notes

2.2-4510 – Corporate notes (AA and above)

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VGFOA Permitted Investments - Abridged

2.2-4515 Collateral & Safekeeping - Securities maturing in more than 31 days must be:

- Held by : 1) public official, 2) municipal corporation, 3) other political subdivision, 4) other public body, or 5) custodial agent
- Held in name of the municipal corporation, political subdivision, or other public body

CAUTION! Custody and Safekeeping are not the same!

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VGFOA Additional Investment Restrictions

- Investment Policy
 - Documented by Treasurer or adopted by board
 - Often includes internal controls and other purchasing rules
- Trust Indenture
 - Sometimes more restrictive than Commonwealth code
 - Trustee has investment responsibility at municipal direction
- Bond Insurance
 - Can be very limiting on credit quality and maturity
 - Some can be modified for a fee

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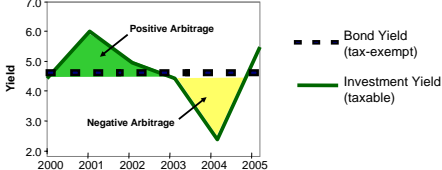
Arbitrage Rebate Regulations

- All earnings on gross bond proceeds in "excess of the bond yield" must be paid to the IRS.
- To ensure compliance, issuers must:
 - invest bond proceeds
 - keep accurate records
 - calculate rebate liability
 - and remit payment, as necessary
- Failure to comply can subject the issuer to stiff penalties AND/OR the bonds may be declared taxable



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What Is Arbitrage?



Arbitrage is the difference between the rate at which the proceeds were borrowed and the rate at which the proceeds were invested.

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Small Issuer Exception

- The issuer does not expect to issue more than \$5 million of bonds in that calendar year (\$15 million for school districts)
 - Issuer must have general taxing powers
 - Bonds must be governmental bonds
 - At least 95% of the proceeds must be used for local governmental activities within the issuer's boundaries

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Spending Exceptions

- 6-Month spending exception
- 18-Month spending exception
 - 15%, 60% and 100%
- 24-Month spending exception for Construction Bonds
 - 10%, 45%, 75% and 100%

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Debt Service Fund Exception

- "Bona Fide" Debt Service Funds are typically exempt from rebate
- Bona-Fide if depleted at least annually except for "reasonable carryover" defined as greater of:
 - the earnings on the fund for the immediately preceding bond year
 - 1/12th of the principal and interest payments on the issue for the immediately preceding bond year

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Penalty in Lieu of Rebate

- Election for Construction Bonds
- 1 ½% of amount by which actual expenditures fall short of each spending benchmark (10%, 45%, 75% and 100%)
- Payments continue until all funds spent
- Payment due 90 days after each 6-month period



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Yield Restriction

- Remaining proceeds must be "yield restricted" after 3 years
- Limited to a rate that is "not materially higher than the yield on the bonds"
- Materially higher is generally defined as a yield which is 0.125% greater than the yield on the bond issue.

Example:

Bond Yield = 5.00%

Maximum Allowable Yield = 5.125%

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Understanding Yield Restriction

- There may be instances, at the end of a fifth bond year anniversary, when an issuer does not owe rebate, but must make yield reduction payments

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Qualified Administrative Costs

- Certain investment costs may be "qualified"
- Qualified administrative costs reduce effective investment return and reduce rebate liability
- Limited to reasonable, direct administrative costs
- Examples:
 - Administrative fees on money market mutual funds
 - Bidding Agent fees on investment agreements

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Calculations and Payment

- Payment required every 5 years
 - Payments can be made at any time
 - After proceeds are spent, liability can be finalized

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Optimal Investment Strategy

- The optimal strategy
 - Safe
 - Liquid
 - Maximizes income
- Stuff happens
 - Project delays
 - Interest rate changes
 - Time passes

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Current Rate Environment

Borrowing vs. Investment Rates

| Term | US Agencies | US Municipal Government Obligations AA |
|--------|-------------|--|
| 3 Mo | ~5.2% | 3.5% |
| 3 Yrs | ~5.3% | ~3.8% |
| 7 Yrs | ~5.4% | ~4.2% |
| 11 Yrs | ~5.4% | ~4.4% |
| 15 Yrs | ~5.4% | ~4.5% |
| 19 Yrs | ~5.4% | ~4.5% |
| 23 Yrs | ~5.4% | ~4.5% |
| 27 Yrs | ~5.4% | ~4.5% |

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Different Situations Require Different Strategies

- **Example 1:** Issues that Qualify for an Exception from Rebate
 - Liquidity for construction draws
 - Maximize earnings
- **Example 2:** Issues that Don't Qualify for an Exception from Rebate
 - Liquidity for construction draws
 - Maximize earnings at the arbitrage yield
 - Build in cushion of arbitrage to hedge against future decline in rates
 - Minimize out-of-pocket expenses (e.g., portfolio management fees, custodian fees) - fees not deductible for arbitrage rebate purposes

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Investment Accounts

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Construction / Project Funds

- Cash flows can be difficult to predict

“Classic S Curve”

“Classic WAG”

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Money Market Mutual Fund

- Interest rates closely track current market rates
- Convenient
- Liquid

* Past performance is no guarantee of future results

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Portfolio of Securities

- Lock-in fixed rate of interest for life of the security
- Market risk if investments sold early and upon valuation dates
- Reinvestment risk if draw schedule is delayed

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Flexible Repurchase Agreement

- A contract in which an investor buys securities from a counterparty who agrees to buy the securities back at a later date at an agreed upon price
- Highly liquid
- Secured by U.S. Treasury/Federal Agency obligations
- Locks in yield
- No market value fluctuations
- Placement fees netted from earnings for computing arbitrage rebate (may result in no out-of-pocket costs to investor)

Transaction Begins

Transaction Ends

| | |
|--------------|---|
| Investor | Counterparty |
| Cash | ← Delivery vs. Payment |
| ← Securities | ← |
| ← Securities | Returned to broker/dealer who re-purchases them |
| ← | Cash + Interest |

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Forward Delivery Agreement

- Also known as: Forward Rate Agreements, Rolling Treasury Agreements, Forward Purchase Agreement
- Locks in yield
- Investor owns short-term Treasury/Agency/Corporate obligations
- Limited market value fluctuations
- Placement fees netted from earnings for computing arbitrage rebate (may result in no out-of-pocket costs to investor)

Provider — Fixed Rate of Return —> Investor
 Securities —> Custodian —> Provider
 Cash —> Custodian
 Investor — Initial Deposit —> Custodian

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Debt Service Reserve Funds

- Special investment requirements
 - Long term investment horizon
 - Bond covenant restrictions
 - Valuation requirements
 - Call provisions on underlying debt

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Debt Service Reserve Fund Strategies

- **Money Market Mutual Fund**
 - Variable rate of return
 - No market value risk
- **Individual Portfolio**
 - Longer-term investments can lock in rates
 - Interest rate risk
- **Forward Delivery Agreement/Flexible Repurchase Agreement**
 - Locks in a fixed rate
 - Investor owns U.S. Government securities
 - No market value risk
 - Qualified administrative costs

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Debt Service Fund

- Sinking Funds - debt service and accrued interest accounts
- Subject to strict investment limitations under Virginia Statute

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Debt Service Fund Strategies

- **Money Market Mutual Fund**
 - Some funds (LGIP) are not permitted investments
 - Investments limited to U.S. Government obligations
- **Individual Portfolio**
 - Limited to short-term securities to cover debt service payments
 - Return is limited
- **Forward Delivery Agreement**
 - Invest short-term funds at yields comparable to longer-term investments
 - Investor owns U.S. Government securities

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Investment Strategy Checklist

- Estimate draw schedule
- Obtain arbitrage yield (or estimate)
- Determine if issue will meet any exception to the rebate requirements
- Compare arbitrage yield to current market rates
- Identify investment objectives
 - Can returns above arbitrage yield be retained?
 - How certain is draw schedule?
- Evaluate alternative investments to determine which best meets investment objectives

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- Keep everything
 - Bond documents
 - Investment records
 - Disbursement documentation
 - Rebate calculations

- Retain for 6 years after maturity of bonds

