Positive Arbitrage: It's Back Again

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pfm asset management

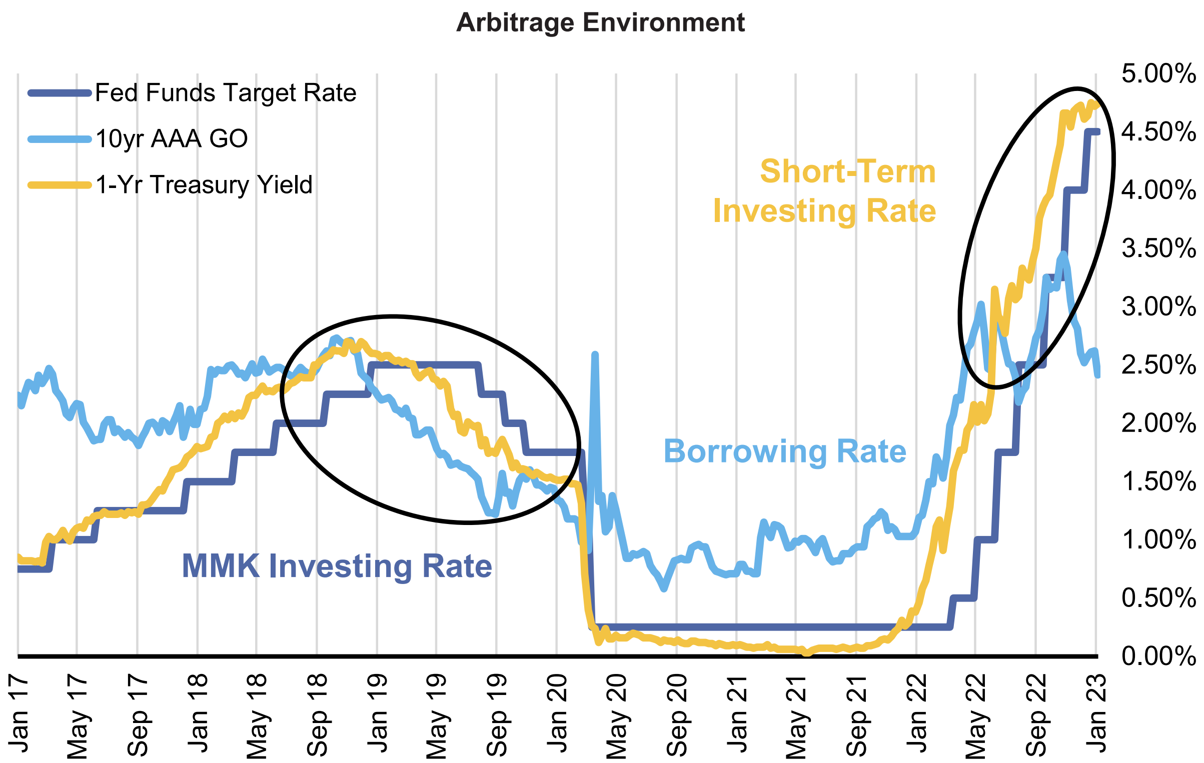
What Issues Could be Affected Right Now?

Earning positive arbitrage becomes more likely as interest rates rise, an upward trend we've seen since mid-2022. That is good news for tax-exempt bond issuers because interest earnings can become a legitimate contributor to project budgets, especially following the onset of the pandemic and near-zero interest rates. But it also means paying closer attention to arbitrage rebate strategy and compliance considerations. At the moment, there are two critical categories of issues to consider:

1. **New and recent bond issues with low borrowing rates (arbitrage yields) that are earning positive arbitrage or will soon earn positive arbitrage.** Good credits and short-term borrowings are the most vulnerable. Any debt obligation with a bond yield of roughly 3% or less has an opportunity to earn positive arbitrage based upon current and reasonably expected market conditions.

2. **Bond issues from 2019 to 2021 with unspent balances in project funds.** If not previously waived, the three-year temporary periods already have or will expire in this higher interest rate environment. Issuers that waived temporary periods in 2019 to 2021 likely made a great strategic move.

The circled regions below indicate periods of a positive arbitrage environment over the past six years:



Sources: Bloomberg.

Spending Exceptions – Use It or Lose It

Monitoring spending of new money bond proceeds is becoming more important than ever. The spending exceptions are rewards from the Internal Revenue Service (IRS) that allow issuers to keep positive arbitrage if they spend bond proceeds quickly. In addition, unspent bond proceeds have been a topic of interest with the IRS, so the timely expenditure of bond proceeds is vital.

Issuers will need to spend proceeds (and interest earnings thereon) based on prescribed six-month benchmark spending requirements to meet one of the three different exceptions (see chart below). Because there is no catch-up provision, once an issuer misses a spending benchmark, the ability to meet the exception is lost. Proactively monitor project draw schedules and consider if a spending exception can be met – meeting the exception and keeping the positive arbitrage earned is a win-win!

6-Month	18-Month	2-Year (ACP)
All gross proceeds	All new money	Construction issues
✓ 6 months 100%	✓ 6 months 15%	✓ 6 months 10%
	✓ 12 months 60%	✓ 12 months 45%
	✓ 18 months 100%	✓ 18 months 75%
		✓ 24 months 100%

Don’t Forget About Yield Restriction

The end of the three-year temporary period to yield restriction for new money bond proceeds, unless previously waived, often sneaks up on issuers when the third anniversary date of the bond issuance comes around. Yield restriction is the second layer of the arbitrage rebate and yield restriction requirements and is calculated in the same manner as an arbitrage rebate liability, the difference is in the timing. At the end of the three-year temporary period, any unspent new money bond proceeds remaining will become subject to the yield restriction requirements – potentially in a vastly different interest rate environment such as that we see in the Arbitrage Environment chart.

The election to waive the three-year temporary period to yield restriction must be made in writing in the tax certificate on the issue date of the bonds. In hindsight, issuers that waived temporary periods in 2019 to 2021 likely made a great strategic move. For issuers that did not waive the temporary period, take a moment to review unspent bond proceeds balances and current investment rates. If investment rates exceed the arbitrage yield on the bonds, begin to prepare for the possibility of a yield restriction liability and a corresponding yield reduction payment to the IRS. Ensure that a plan is in place to continue to spend bond proceeds down with due diligence.

Calculation and Filing Requirements

If a positive arbitrage rebate and/or yield restriction liability has accrued on a bond issue, a payment must be made timely to the IRS to remain in compliance. The installment computation date at which any accrued liability must be paid will fall no later than five years after the issue date, and every five years thereafter until the final maturity or redemption date of the bonds.

Rebate and yield reduction payments must be postmarked to the IRS within 60 days of the installment or final computation date. At least 90% of the accrued liability must be paid at an installment date, with 100% of the liability due as of the final computation. If both an arbitrage rebate and yield restriction liability has accrued, only the greater of the two must be paid. Issuers will need to mail a check for the liability amount and the IRS Form 8038-T; the supporting calculations are not to be submitted. No filing is required with the IRS if there is no payment due. Timely payments are essential – filing a late payment requires additional late interest to be paid, possible penalties, and a written explanation for the cause of the late payment.

Final Thoughts

Here are some strategies to consider when monitoring and mitigating potential risks:

- **Engage a rebate analyst now,** even for new bond issues. Fifth year reporting is a must; annual reporting is better especially while proceeds are outstanding.
- **Talk to your rebate analyst and financing team in advance of pricing** to discuss strategy and tax implications of your deal.
- **Monitor 6-month spending benchmarks** for new money bonds. Meeting a spending exception means you will get to keep all earnings including any positive arbitrage earned.
- **Missed a spending benchmark?** Have your rebate analyst start preparing annual liability calculations so there are no surprises.
- **Connect with an investment advisor** to make sure bond proceeds are not only invested, but invested wisely. Bond proceeds sitting in uninvested cash could be earning retainable interest.
- When doing a refunding, **talk to your rebate analyst about preparing final arbitrage reports for the bonds refunded.**
- If you issued new money debt in 2019-2021, **review unspent project fund balances** and determine if temporary periods have expired or will be expiring soon.
- **Schedule arbitrage rebate and yield restriction calculations** to prevent exposure to unnecessary risk.
- **Remit arbitrage rebate or yield reduction payments to the IRS within 60 days of the installment or final calculation date**, late payments are subject to late interest and possible penalties.

To learn more or discuss in greater detail, please contact us:

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