Positive Arbitrage — It's Back

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What Issues Could be Affected Right Now?

Earning positive arbitrage becomes more likely as interest rates rise. That is good news for tax-exempt bond issuers because interest earnings can become a legitimate contributor to project budgets. But it also means paying closer attention to arbitrage rebate strategy. At the moment, there are two critical categories to consider:

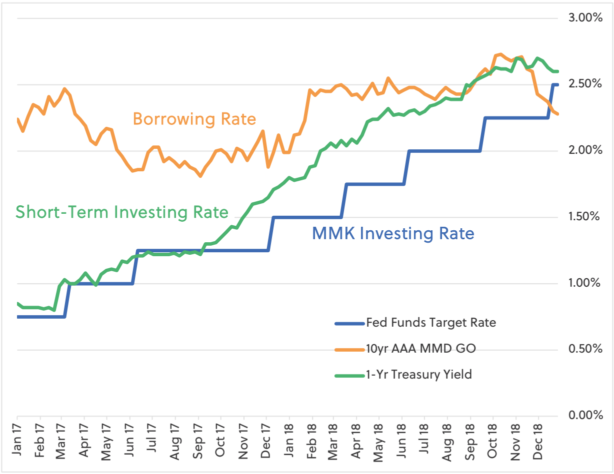
1. **New bond issues with low borrowing rates (arbitrage yields) that are earning positive arbitrage or will soon earn positive arbitrage.** Strong credits and short-term borrowings are the most likely to require attention. Any debt obligation with a bond yield of roughly 3% or less has an opportunity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

2. **Bond issues from 2014 to 2016 with unspent balances in project funds.** If not previously waived, the three-year temporary periods will expire in this higher interest rate environment. Issuers with waived temporary periods could realize benefits in the current market environment.

Waiving the Temporary Period

Even with rates rising, it may still make sense to waive the three-year temporary period on new project funds. The tables below may help you decide whether this is a conversation worth having with bond counsel.

Arbitrage Environment



Sources: Bloomberg, Thomson Reuters

Draw Schedule	Arbitrage Yield		
	Low (2%)	Mid (3%)	High (4%+)
Short (<18 months)	NO	MAYBE	MAYBE
Medium (18-24 months)	NO	MAYBE	YES
Long (>24 months)	MAYBE	YES	YES

Note that the information shown in the table above is based on current market conditions and current expectations for borrowing rates (arbitrage yields) on debt and investment rates for bond proceeds.

Remember that evaluating whether or not to waive the temporary period is a conversation to have with bond counsel while preparing the bond issue. It is a tax election that must be made in writing at settlement and cannot be changed thereafter.

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 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, making the timely expenditure of bond proceeds vital.

Clients have to spend proceeds (and interest earnings) based on prescribed six-month benchmark spending requirements to meet an exception (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.

Spending Exception	6 Months	12 Months	18 Months	24 Months
6-Month | All Gross Proceeds	100%			
18-Month | All New Money	15%	60%	100%	
24-Month | Construction Issues	10%	45%	75%	100%

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 transaction.
- 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.[1]
- When executing a refunding, talk to your rebate analyst about preparing final arbitrage reports.
- If you issued new money debt in 2014 through 2016, review unspent project fund balances, and determine if temporary periods have expired or will be expiring soon.
- Schedule arbitrage rebate calculations to help prevent exposure to unnecessary risk.

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