



## Arbitrage Is Not A Four-Letter Word

By Lori Raineri

**A**rbitrage has taken quite a beating during the past year. First, Capitol Hill dealt a severe blow to arbitrage earnings on tax-exempt municipal bond issues with the Tax Reform Act of 1986. Then Wall Street suffered an insider trading scandal involving arbitrageurs. However, arbitrage earnings are not completely eradicated from the municipal balance sheet. There are still limited opportunities for cities to earn arbitrage profits.

As defined by Webster's Dictionary, arbitrage is the "simultaneous purchase and sale of the same or equivalent security (as in different markets) in order to profit from price discrepancies." Traditionally, what this has meant for municipalities is an opportunity to earn a profit on the spread between tax-exempt municipal bond rates and taxable investment rates. Since the interest on municipal bonds is tax-exempt, the marketplace has placed a lower yield on municipals to reflect the advantage of tax exemption. Historically, the interest rate spread between taxable and tax-exempt bonds of comparable security and maturity has ranged from one to four percentage points.

Arbitrage could be achieved in the following way. A municipal issuer, such as a city, would simultaneously issue, for example, \$10 million of tax-exempt

bonds with an interest rate coupon of seven percent. The city would invest the \$10 million in a taxable investment (such as Treasury bonds or a guaranteed investment contract) yielding ten percent until the funds were needed. This three-percent differential was profit to the city. Generally, the taxable investment was pledged to secure the debt service on the tax-exempt bonds.

In essence, the city was purchasing an investment in the taxable market and selling it in the tax-exempt market and profiting from the price discrepancy between the taxable and tax-exempt markets. It was unusual, however, for municipalities to issue tax-exempt bonds purely for arbitrage. The arbitrage earnings were an incentive to early issuance of debt, but most issuers did have a need for the funds. Prior to the Tax Reform Act of 1986, arbitrage was allowed during a three-year "temporary period." Municipalities could often earn from three to five percent of the cost of a bond-financed project through arbitrage earnings during the temporary period. At the end of the temporary period (or earlier, if funds were needed), the taxable investment would be liquidated and the funds used for whatever purpose the bonds were initially issued.

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**C**ongress, in its efforts to increase revenues to the federal treasury while producing the Tax Reform Act of 1986, focused on the arbitrage earnings of local government. An argument was made that the arbitrage incentive to issue municipal debt created more municipal debt than otherwise would have been issued and diverted investment dollars from investments which would produce tax revenue to the federal government. Critics have argued that, without the cost savings of arbitrage earnings, municipalities must issue more debt to cover the cost of a project. In any case, the Tax Reform Act did not bode well for arbitrage between the tax-exempt and taxable markets.

The Tax Reform Act's arbitrage provisions consist of three distinct limitations: (1) investment yield limitations, (ii) reserve fund sizing restrictions, (iii) rebate requirements. Violation of any one of these three limitations will cause a municipality's bonds to become "arbitrage bonds," and the bond interest will be taxable retroactive to the date of issuance.

The investment yield limitations limit the yield which can be earned on invested bond proceeds. Generally, investment earnings cannot exceed one-eighth of one percent over the bond yield. However, during the temporary period (the construction period), the investment yield limitations do not apply.

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## Arbitrage (continued)

The reserve fund sizing restrictions essentially limit the amount of the reserve fund to be funded from bond proceeds to 10 percent of total bond proceeds. The rebate requirements provide that an issuer must rebate to the U.S. Treasury investment earnings on bond proceeds in excess of the bond rate. However, if bond proceeds are expended within six months of the date of issuance, the rebate rules do not apply.

The essence of the arbitrage provisions of the Tax Reform Act is that arbitrage earnings are not allowed except during a six-month "temporary period." Currently, there is about a 40 basis point (.40 percent) interest rate spread between 10-year "AAA" rated tax-exempts and six-month Treasury Bills. So, if a municipality issued \$10 million of 10-year "AAA" rated bonds, it could invest bond proceeds in six-month Treasury Bills and earn the 40 basis point spread during the six-month temporary period, which translates into \$20,000. Obviously, this is not a sufficient amount to encourage arbitrage-driven bond issues, but it is an opportunity of which municipalities should take advantage. Furthermore, since all bond issues involve a certain amount of costs of

issuance, this \$20,000 will defray a small part of that expense.

The risk inherent in violating the arbitrage provisions of the Tax Reform Act is a retroactive determination that interest on a municipality's bonds is taxable. Such a determination probably would result in bondholder lawsuits. Therefore, it is crucial that municipalities ensure bond documents are properly prepared to provide the bond trustee adequate authority to take whatever steps are necessary to comply with the investment yield limitations and rebate requirements. It also is essential that the flow of funds is structured so funds are available to the bond trustee for any anticipated rebate to the federal treasury.

**D**espite the severe arbitrage restrictions in the Tax Reform Act, arbitrage earnings are not entirely a thing of the past. The Tax Reform Act, appropriately, addresses itself only to arbitrage of tax-exempt debt and taxable investments. Municipalities do have the legal authority to earn arbitrage profits on any spread which might exist between the *taxable* municipal bond market and taxable investments.

The taxable municipal bond market is a new market. According to Securities Data Co., no taxable municipal bond is-

ssues took place in 1984. This is not surprising; there was no incentive for municipalities to issue taxable debt when they could achieve an interest cost savings through their ability to issue tax-exempt bonds and still finance their projects. However, during the last two years, the impending tax bill and the shrinking list of projects and project costs which qualified for tax-exempt financing under federal law caused many municipal bond issuers to turn to taxable bonds to avoid onerous restrictions such as the arbitrage provisions.

During the first part of 1986, the taxable municipal bond issue most likely to be driven by arbitrage earnings was one sold overseas. When the dollar and U.S. interest rates were high relative to the yen and Japanese rates, as it was in late 1985 and early 1986, there was a positive spread between the interest earnings on domestic investments and the interest cost on bonds sold overseas. In December, 1985, the Indiana Housing Authority sold a \$200 million bond issue which was largely driven by arbitrage earnings. At the time of issuance, Julian Ridlen, Indiana's treasurer, said that the transaction was "essentially an arbitrage . . . to take advantage of extraordinarily attractive investment returns." A significant portion of the issue was

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## Arbitrage

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sold abroad — \$79 million in Japan and \$10 million in Great Britain. Instead of originating mortgages with bond proceeds, as would have been required for a tax-exempt issue, bond proceeds were used to purchase Government National Mortgage Association securities, which were used as collateral for the bond issue, and to the extent the returns exceed the debt service owed by the Authority, those funds (arbitrage earnings) are used to originate below-market mortgages. So, Indiana took advantage of a price differential in two taxable markets (foreign and domestic) and used the arbitrage earnings to accomplish its function as an originator of below-market mortgages to provide housing in the state.

In 1986, a different type of arbitrage-driven taxable bond issue was widely used. This was a taxable bond issue backed by a guaranteed investment contract (G.I.C.) in which an insurance company guarantees a specified return on the investment of bond proceeds. Such issues carry the debt rating of the claims-paying ability of the insurance company.

The structure of these transactions was similar to those tax-exempt issues secured by guaranteed investment contracts sold during the days of the three-year "temporary period," during which arbitrage was permitted (prior to the Tax Reform Act of 1986). In such tax-exempt transactions, bond proceeds would be deposited with an insurance company and withdrawn on a schedule which reflected the construction draws of a project. Often, there would be a relatively long period during the beginning of the term of the guaranteed investment contract when there would be no draws, because the municipality was maximizing its investment earnings to create an arbitrage profit. Further, the guaranteed investment contract would be pledged to secure the bonds until the project was completed. Any differential between the interest earned on the guaranteed investment contract and the interest due on the bond issue was arbitrage profit to the municipality. However, one essential feature of such a transaction (to avoid abusing the right of tax-exempt debt issuance), was that there be a realistic expectation on the part of the municipality that the bond proceeds eventually would be used to finance a project.

In 1986, \$3.72 billion of taxable mu-

nicipal securities were sold. Issues secured by guaranteed investment contracts made up \$2 billion of the total. These taxable G.I.C. transactions are extremely controversial. Critics claim the public purpose behind each issue is dubious. While the issues were ostensibly to provide loans for activities such as housing, agricultural development, and industrial development, most or all of the proceeds never were intended for loans but were to be used to earn arbitrage profits. Because the interest rate spread is relatively small between the taxable markets, the deposit and withdrawal of bond proceeds are so restricted it may not be practical to withdraw funds to make loans. Furthermore, to attract sufficient G.I.C. rates, this kind of taxable issue must be relatively large. Critics point out that just ten issues comprised the entire \$2 billion of G.I.C.-backed taxable bonds sold in 1986, resulting in a monopolized market.

This controversy has widened the spread between outstanding issues relative to Treasury bonds; the interest rate required to sell a G.I.C.-backed bond issue is now so high that it is difficult for insurance companies to write guaranteed investment contracts at a yield level which is profitable yet fits the needs of the municipal bond issuer.

Even though a G.I.C.-backed taxable municipal bond issue may not result in the origination of loans from bond proceeds, it may produce sufficient arbitrage profits to fund loans or other governmental activities in need of funding. This was the case with the Indiana transaction previously described.

Arbitrage is not necessarily inappropriate for a public agency. When arbitrage is earned in accordance with the law and used for a public purpose, the municipality maximizes its resources. When an insurance company enters into a G.I.C., it is selling its own corporate debt. The city enhances the sale of that debt by utilizing two of its resources: its ability to attract municipal investors and its ability to sell bonds to small "retail" investors. (Often small "retail" investors are satisfied with a lower rate of return than large "institutional" investors.)

Arbitrage is not an anathema for municipal government. Legal methods of earning arbitrage such as taxable bond issues or the six-month temporary period exception should be sought and utilized. With cities facing more financial hurdles than ever before, every dollar earned through legal arbitrage is another dollar in the city treasury. ■

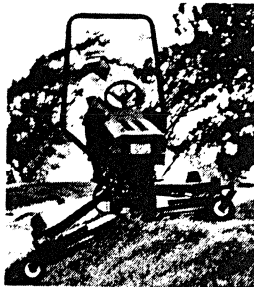
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