Chapter 11

INVESTMENT OF BOND PROCEEDS

EVALUATING INVESTMENT ALTERNATIVES

There are three major classes of financial products available for the investment of bond proceeds:

- Individual securities or a portfolio comprised of such securities
- Investment agreements
- Mutual, or pooled, investment funds, including money market funds

As described below, there are subcategories of these major classes, which, in the aggregate, provide the municipal investor with adequate tools to design and implement a bond proceeds investment strategy that accomplishes the investment objectives described earlier in this chapter.

Individual Securities or Structured Portfolios

Generally, these securities are limited to direct obligations of the U.S. Treasury, obligations of federal agencies that are directly or indirectly guaranteed by the United States, and debt obligations of other entities—including corporate for-profit entities—that are of exceedingly high credit quality and relatively short duration. In addition, in most circumstances equity or stock investments are prohibited for municipal issuers under Article XVI, Section 6 of the California Constitution. It is important to remember, however, that while these securities generally contain little credit risk, they can be subject to substantial market value volatility if purchased with an inappropriately long remaining time period to maturity. Because the value of equity securities is inherently volatile, they run afoul of the safety first rule and are seldom permitted for bond proceeds or public funds investments.

As with the other financial products available as investment alternatives, individual securities work better or worse according to the fund in which they are contained and other circumstance-specific factors. However, a strategy of combining several types of securities with varying maturity and interest payment dates can often provide almost perfect credit safety with minimal liquidity risk and adequate yield performance. Combining individual securities with other financial products affords even greater flexibility to address specific circumstances. Finally, how individual securities are purchased can affect the balance between safety, liquidity, and yield.

Investment Agreements

As the name suggests, an IA is a contract providing for the lending of issuer funds to a financial institution, which agrees to repay the funds with interest under predetermined specifications. However, this description is often as much as two IAs will have in common as security, liquidity, yield, and administrative provisions can vary significantly among members of this very broad category. It is this flexibility in creating IA terms that often allows a properly structured IA to be an attractive vehicle for investing bond proceeds. Under favorable market conditions, IAs can offer:

- A fixed interest rate in excess of otherwise appropriate individual securities
- Daily or otherwise appropriate liquidity
- Virtual elimination of reinvestment risk and administrative and brokerage costs and fees
- Credit quality at least equal to that of seven-day primary dealer repurchase agreements

However, lack of industry standardization among IAs and limited investor familiarity may result in poorly structured agreements that are problematic and generally unsafe for the issuer. By familiarizing themselves with IA types and terms, issuers can avoid pitfalls and, when such an investment vehicle is appropriate, structure the IA that best meets a given set of circumstances.

An IA type is largely determined by its security provisions, especially those related to collateralization, its withdrawal and payment provisions, and by the type of financial institution providing the IA. Examining each determinant provides useful insight into the advantages and disadvantages of various types of investment agreements.

Security Provisions. Because an investment agreement is essentially a promise to repay funds at specified times and rates of interest, the single most important consideration with respect to purchasing an IA is the provider's ability to make good on these promises. Most IA providers, especially those qualifying under the permitted investments section of a bond indenture, are insurance companies, banks, or primary U.S. government securities dealers with repayment ability for both short-term and long-term obligations that are rated by firms such as Moody's Investor Services, Standard & Poor's or Fitch Ratings.

Credit Rating. While the credit rating is the best place to start in evaluating the safety of a particular IA, it is important to note that repayment ability may change subsequent to executing the agreement. There have been defaults on IAs that, when originally structured, were considered safe and prudent investments. Safeguards against default include both selecting only the strongest providers and limiting contract length thus making an unforeseen quick and deep deterioration in financial condition much less likely. Determining the longest safe IA term is a job for hindsight. Recent history suggests that drastic changes in institutions and national economies can take place over the course of weeks or even days. Because shorter term IAs can bear less than attractive interest rates and expose an issuer to reinvestment risk upon maturity, providers and issuers alike often turn to forms of collateralization to provide the requisite security on longer term IAs. Another option is to include termination provisions, which allow an issuer to liquidate the security in the event the provider's credit rating is downgraded or to require the provider to post additional collateral.

Collateralization. Collateralization can vary according to the amount and type of collateral, the frequency of its valuation (i.e. how often it is marked to market), and the holder of the collateral. The safest type of collateral arrangement involves a third-party collateral agent who holds securities backed by the full faith and credit of the United States for the benefit of the issuer. The collateral requirement can be equal to or somewhat in excess of the IA balance and determined weekly (or less frequently) by the collateral agent. Most collateral agreements require the provider to cure collateral deficiencies within seven days. In the event of default under the IA, the collateral agent will liquidate the collateral and remit to the issuer amounts equal to the then outstanding IA balance. If properly structured, the collateral agreement will create a perfected third-party interest in the collateral, thereby avoiding the possibility that a bankruptcy court could attach the collateral as an asset of the IA provider. This structure is less prone to market risk than the purchasing of treasuries and/or agencies with comparable maturities.

It should be noted that collateralization is a cost to the IA provider and is passed on to the issuer in the form of lower yields on its investment. However, if an IA collateralized as previously described still yields in excess of the bond yield, the issuer should be indifferent to such cost. To the extent the collateralized yield is below the bond yield, the issuer must weigh the increased risk versus higher yield. Compromises between fully collateralized IAs and uncollateralized IAs also are possible. These include reduced collateral requirements and less frequent mark-to-market provisions, but more often employ a downgrade provision. Downgrade provisions are used with initially uncollateralized IAs and require the provider to post collateral upon its credit rating being downgraded below a specified level. This approach reduces costs during periods of continued financial strength while securing the issuer at the first sign of trouble. While solid conceptually, these provisions are dependent upon sufficient advance notice of financial trouble. Notice can come too late for the provisions to be enforced prior to default.

Withdrawal and Interest Payment Provisions. Among an IA’s greatest strengths is the ability to tailor withdrawal and interest payment provisions to exactly meet bond proceeds expenditure requirements while eliminating reinvestment risk and the costs associated with monitoring investments and paying brokerage and management fees. Of course, greater flexibility for the issuer will always come at the expense of yield. The issuer hopes that a full flexibility IA will still bear an interest rate in excess of the bond yield. If not, a tradeoff of liquidity for yield must be evaluated. This tradeoff can be mitigated if a reasonably accurate construction schedule is available. Obviously, IAs work well for capitalized interest and reserve funds that require little or no flexibility since the cash requirement dates and amounts for these funds are known factors. The range of available withdrawal and interest payment provisions in decreasing order of flexibility—and increasing order of yield—can be characterized as follows:

- **Full-Flex**. This choice provides for daily withdrawals up to the full amount of the IA (for project purposes, not alternative investments), any desired interest payment dates or frequency, and automatic reinvestment of interest earnings at a specified yield. Any of these terms, including notice requirements for withdrawals, can be relaxed in an effort to create additional yield. Full-flex is most useful strategy for construction funds.

- **No Sooner, No Greater**. This choice provides that the issuer may make withdrawals only after a specified date in a not-to-exceed amount, and may or may not provide for reinvestment of interest earnings. The increased average life and predictability of repayment requirements usually results in higher yields but can expose an issuer to the possibility of cash flow shortages. No sooner, no greater is often used in conjunction with small deposits to money market funds or similarly liquid investment vehicles to address this concern. This type of provision is best suited to construction funds for phased projects or where highly accurate draw schedules are available.

- **Bullet Draws.** This choice provides for pre-determined withdrawal and interest payment amounts and dates. Exceptions are limited to indenture requirements such as default, mandatory redemption of bonds, and a reserve fund draw. Bullet draws provide the highest yield available, but have little flexibility. They are almost always used in conjunction with more liquid investments, or when there exists an extremely high degree of confidence in cash flow requirements such as in capitalized interest and reserve fund applications.

- **Investment Agreement Providers.** The following is a list of typical IA providers:

    - **Insurance Companies**. These were among the first institutions to make IAs available for bond proceeds investment. Often referred to as guaranteed insurance contracts (GICs), these securities are typically guaranteed only by the repayment ability of the insurance company. While these institutions often have huge asset bases, there have been instances of default among providers of these uncollateralized IAs.

    - **Banks.** Often referred to as bank investment contracts (BICs), these securities can be thought of as a flexible series of certificates of deposit (CDs). They may or may not be collateralized and are typically issued only by the largest and most creditworthy banking institutions.

    - **Primary U.S. Government Securities Dealers.** These institutions issue repurchase agreements (repos), which, by their nature, are collateralized. A

> repo involves an issuer's purchase of a security backed by the full faith and credit of the United States government and the provider's agreement to buy the security back from the issuer on a specified date and price, with the interest rate of the agreement being a function of the repurchase price and other payment terms. While the securities subject to the repo (or flex-repo, which can be thought of as a more flexible series of repos or a repo with respect to a pool of securities) belong to the issuer during the term of the repo, collateral valuation and holding is subject to negotiation.

Obtaining an Investment Agreement. Once a decision to explore the investment of bond proceeds in an IA is made, an issuer should authorize an experienced IA intermediary to present alternative investment strategies. This should involve a thorough analysis of the following factors:

- Guidelines established in the issuer's investment policy
- Permitted investments allowed under the bond indenture
- Maximum allowable yield under arbitrage restrictions and rebate requirements
- Expected cash flow requirements of all funds
- Prevailing interest rates on permitted IAs

The IA intermediary will then work with the issuer to develop a structure that best meets the requirements of the bond issue in terms of security, liquidity, and yield. If all the investment objectives cannot be met in the current interest rate environment, the issuer may decide to make tradeoffs in terms of the structural criteria or to wait until the IA market improves. It should be noted that normally the IA intermediary's fee is paid by the IA provider upon successful completion of a transaction and therefore an issuer will not incur any costs if this process is delayed or never completed.

If the issuer is satisfied with the structure of the IA, authorization to proceed with bidding process is given to the IA intermediary who will draw up a request for IA bids or bid form, which carefully states all the requirements of the desired IA structure and explains the bidding procedure. The bid form also should state any other conditions that the winning provider must meet to complete the transaction. These requirements include:

- Circulating a draft of the actual IA contract within a specified time
- Providing a legal opinion as to enforceability of the contract
- Payment by the winning provider of all of its own legal fees
- Supplying the issuer with monthly status reports and any other requirements the issuer deems necessary

There are two steps a prudent IA intermediary can take that should eliminate any risk of future regulations causing an issuer to incur any additional arbitrage rebate liability:

Bidding Yield. Since the U.S. Treasury has indicated that the terms of an investment should be based on the reasonable and realistic needs of an investor without regard to the arbitrage rules, the criteria for selecting the winning IA provider should be based on the highest yield rather than fixing the yield and bidding some form of the liquidity or security features. A permissible variation on this concept is to set the interest rate on the IA to the arbitrage rate on the bonds and to bid for an up-front premium payment (assuming that IA yield is higher than the bond rate). This premium represents an approximation of the present value of the issuer's rebate liability on that particular investment.

No-Fee Bidding. The IA should be bid in a manner that will eliminate the possibility that the fee, which the IA intermediary receives from the IA provider, could be considered additional yield to the issuer, and therefore increase its arbitrage rebate liability. Although the fee is paid directly by the provider, there is a risk that the IRS may determine that the IA intermediary is acting as agent for the issuer, which would make the fee a nonrecoverable expense. The final U.S. Treasury regulations published in 1993 do provide some explicit guidance as to what may be paid as a brokerage commission and still not be treated as additional yield to the issuer. The maximum allowable fee is equal to the present value of five basis points times the expected invested balance for each year that the contract is in effect. It is generally advisable that in connection with obtaining an IA, the issuer request written confirmation from the IA intermediary detailing fees paid to the IA intermediary by the selected IA provider.

The bid form will be sent out several days in advance of the anticipated bid to all potential IA providers who can meet the issuer's security criteria. The IA intermediary will contact all potential bidders to answer any questions regarding the proposed structure and will provide additional information about the issuer, if necessary. At the time of the bid, the IA intermediary will receive all the bids from the providers and then inform the issuer of the results. A decision to accept the winning bid or to reject all bids should be made promptly. The IA intermediary then informs all bidders of the final result. If all bids are rejected, the issuer can elect to change the bidding criteria and solicit bids again or to put the whole process on hold.

If a satisfactory bid has been received, the winning IA provider will circulate a draft of the IA contract which the issuer and its counsel will review and comment on until all parties are satisfied with its form. Finally, at the settlement of the transaction, the issuer will direct its trustee to send a federal funds wire to the IA provider who will release the IA contract as well as the required enforceability opinion. Additionally, the IA intermediary will provide a certificate assuring that the IA provider was selected in an arm's length transaction. As part of this certificate, it is important that the issuer receive written confirmation from the IA provider and the IA intermediary disclosing all fees paid to the interested parties in connection with obtaining the IA.

IAs are extremely flexible instruments which, when properly structured, can be excellent bond proceeds investment vehicles. Not only can a single IA be a safe, liquid, high yielding investment, several IAs can be used in concert to further these objectives. An example would be to obtain individual IAs for construction, capitalized interest, and reserve funds with the expectation that the less liquid and/or longer term IAs would offset relatively lower yields in the full-flex construction fund. IAs also may be used concurrently with other investments when beneficial.

The market for IAs has become much more competitive and sophisticated in recent years. Among the results of the proliferation of IAs are enhanced security and yield to issuers, as well as the development of innovative structures designed to comply with permitted investments limitations and other restrictions.

Pooled Investment Funds

Pooled investment funds available for local agency bond proceeds investment include commercial, for-profit mutual funds and public sector, not-for-profit pools. Both types of pooled investment funds attempt to leverage economies of scale in professional management, purchasing power, transaction costs, credit risk diversification, and liquidity requirements to improve upon what a smaller or less experienced investor could accomplish through purchases of individual securities.

Commercial mutual funds can be broken down further into money market funds and all others. Money market funds are, by federal law, designed to maintain a constant share price of one dollar for every one dollar invested, and no money market fund has ever failed to do so. Money market funds generally buy only U.S. Treasury and agency securities, repurchase agreements for those securities, and the highest credit quality corporate commercial paper and other short-term indebtedness. The average life of investments in a money market fund may not exceed 90 days. Money market fund mechanical liquidity ranges from zero to three days. Not all money market funds are permitted investments under Government Code Section 53601, local investment policies, or traditional permitted investments language.

Commercial mutual funds that are not money market funds are seldom permitted investments for bond proceeds. They may contain highly volatile securities and, consequently, pose significant credit and market risk concerns. Pooled investment funds that are sponsored or managed by counties, large cities, and the State Treasurer's Office have widely varying characteristics. While they often offer an administratively simple option for smaller local

Pooled Investment Providers

- ✓ State Local Agency Investment Funds (LAIF)
- ✓ County treasurer pooled investment funds
- ✓ JPA pooled programs
- ✓ Bond insurer-sponsored pools
- ✓ Bank-sponsored pools

agencies, it is important to understand the credit, liquidity, and yield characteristics of each fund. Because these funds are not highly regulated, their managers may have very different philosophies that impact net asset value, liquidity, and, ultimately, safety. Before investing in such pools, local agencies should study the type and average life of underlying investments and fully understand deposit, withdrawal, interest payment, and interest allocation provisions. There are many types of pooled investment providers—see text box on **Pooled Investment Providers**. Local agencies should not assume that a pooled investment fund is managed in a manner consistent with the local agency's specific investment policies simply because it is sponsored by a larger, more sophisticated public agency.