Massachusetts School Building Authority

Timothy P. Cahill
Chairman, State Treasurer

Katherine P. Craven
Executive Director

To: Administration, Operations and Finance Subcommittee
Massachusetts School Building Authority

From: Katherine Craven
Executive Director

Subject: Arbitrage Rebate Overview

Date: November 9, 2010

Federal law requires tax-exempt debt issuers to rebate "excess earnings" on certain investments funded with tax-exempt bond proceeds. Excess earnings occur when the yield on a bond funded investment is greater than the interest cost of the tax-exempt bond issue. Simply put if the bonds are issued at 4.0% and the bond proceeds are invested at 5.0%, that additional 1% earned must be rebated to the federal government. The most common situation requiring a rebate payment is the existence of a debt service reserve account.

Rebate came into existence as part of the Tax Reform Act of 1986. There were a series of cases where highly rated tax-exempt issuers parked bond proceeds for a while in taxable higher yielding investments and pocketed the difference. Those transactions were viewed as somewhere between being an abuse and a scandal. Legislation was enacted to prohibit those arbitrage actions. The intent of the rebate requirement is to discourage issuers from simply issuing tax-exempt debt and investing the proceeds in higher yielding taxable debt.

Rebate regulations require issuers to every five years look at the earnings on their unexpended bond proceeds and determine if there are any "excess earnings". If there are any such earnings the issuer must send in 90% of the amount. Once a bond issue is retired one final calculation is done and a final payment equal to 100% of the "excess earnings" is paid.

The MSBA has four Debt Service Reserve accounts which are earning more than the interest cost on the related bond issue. Our annual financials back out from interest income the amount that eventually will be rebated to the federal government. Each year the interest earnings subject to rebate are transferred into a separate restricted account which is eventually used to pay the rebate. This means that there is no impact on the budget or finances of the MSBA in the year a rebate payment is payable.

The MSBA did a competitive procurement for a firm to calculate rebate and selected AMTEC. As of August 15, 2010, AMTEC calculated the 2005A debt issue to have a rebate liability of $9,477,013 on earnings of $86,287,892. This results primarily from the Debt Service Reserve being invested to yield 4.80% and the permitted arbitrage yield is 4.033%. The due date for this payment is October 15, 2010. The required tax payment was made in early October.

Timothy P. Cahill
Chairman, State Treasurer

Katherine P. Craven
Executive Director

To have a rebate liability is actually good. It means funds are being invested to achieve the highest return permitted by federal statute. Two other issuers who have paid rebate are the Massachusetts Water Resources Authority and the Massachusetts State College Building Authority. I am certain that other Massachusetts issuers have also paid rebate.