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Higher Interest Rates Create Opportunity and Potential Liability

As of this date, the Federal Open Market Committee (FOMC) has increased short-term interest rates eleven times in the last sixteen months to combat inflation. As a result, interest rates on short-term investments have increased dramatically, providing higher yields on Treasury securities and other investments permitted under the Connecticut General Statutes for municipalities. Municipalities can invest general fund moneys at these rates to increase investment income for their budgets. Investing the proceeds of tax-exempt obligations at yields higher than the yield on the respective bonds or notes, however, can create a potential liability to the United States Treasury.

Section 7-400 of the Connecticut General Statutes provides for investments in the obligations of the United States of America (including Treasury bills, notes, and bonds), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal National Mortgage Association (Fannie Mae), the Government National Mortgage Association (GNMA), and certain other agencies. It also provides for investments in money market accounts, mutual funds, investment trusts, and other custodial arrangements investing in such obligations if certain requirements are met. Section 7-400 also permits investment in obligations of any state of the United States or of any political subdivision, authority, or agency thereof rated at least "AA/Aa," and obligations of the State of Connecticut or any city, town, and regional school district in Connecticut rated at least "A." Section 7-402 of the Connecticut General Statutes provides for investments in high yield savings accounts and certificates of deposit if certain requirements are met. The State's Short Term Investment Fund (STIF) is also an option. These investments are currently yielding in excess of 3%, 4%, and even 5%, depending on term, which can generate significant investment income for municipalities compared to prior fiscal years. Longer term investments can lock in these higher rates for future fiscal years. Municipalities may wish to consult their investment financial advisors and appropriate legal counsel to consider these investment opportunities.

Investing the proceeds of tax-exempt bonds and notes in higher yielding investments can result in arbitrage rebate liability. Arbitrage rebate liability occurs when a municipality issues tax-exempt obligations, fails to meet an expenditure exception, and invests the proceeds at a yield higher than the yield on the respective bond or note issue. Expenditure exceptions are detailed in your tax regulatory agreement. Under Treasury Regulations, any arbitrage rebate payment is due to the United States Treasury 60 days after each five-year anniversary of the issue date of the bonds, or within 60 days of the final maturity or full redemption of the issue. Shorter payment deadlines apply to notes once an expenditure exception no longer applies. In prior years, arbitrage rebate was not an issue because it was nearly impossible to invest at yields in excess of bond or note yields. However, arbitrage rebate liability is a special concern these days due to the possible delay in project construction during the COVID-19 pandemic and the rapid increase in interest rates. Unspent proceeds may now be invested at yields above the bond or note yield, accruing arbitrage rebate liability to be paid in future fiscal years.

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