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# Current Outstanding Variable Rate Bonds with Swaps: Interest Rate Issues Related to Adverse Changes in the Financial Markets

## Informational Report

The University has variable or floating interest rate bonds outstanding as part of its long term debt strategy. Most of these variable interest rate bonds are combined with swaps that were intended to fix the interest rate of the bonds through their maturity. All of the Series 2001, 2002 and 2004 bonds, and approximately half of the Series 2003 bonds have been swapped to a fixed interest rate. Due to changes in the auction rate securities market where the interest rate on the University's variable rate bonds are priced, the related interest rates are going up. This is having the unintended impact of raising the net effective interest costs for each of these related bond series when taking into consideration the related swaps.

There are two primary alternatives that the Administration is evaluating to mitigate these rising interest rates. One alternative is to convert the bonds from auction rate securities to variable rate *demand* bonds. The other alternative is to replace the existing bonds with natural fixed interest rate bonds.

The Administration is authorized to implement either of these actions by prior Bond Resolutions approved by the Board of Governors.

## Background

There are two primary types of variable interest rate markets, the auction rate securities market and the variable rate demand bond market. The University presently uses the auction rate securities market to periodically establish the variable interest rates that are used to determine the interest expense paid on these bonds. This market was initially selected, instead of the variable rate demand bond market, because of more attractive overall costs. The cost benefit was due, in part to the bond provisions that bond holders were willing to accept (which do not guarantee the bondholder the right to redeem the bonds prior to maturity) and there was no need for a liquidity facility and its related costs.

Within the auction rate securities market, there have been recent market changes that have led to increases in the interest rates that bondholders require in these auctions. There is concern that future interest rates in this market could rise even more. These rising interest rates are a result of the greater demand for liquidity by bond holders and investment banks since this summer's financial/credit crisis (caused by the sub-prime mortgage disruption) and also because of the recent concerns about bond insurers' credit worthiness. The concerns with the bond insurers are also primarily due to this financial/credit crisis and the impact that it would have on their financial strength, thus creating the possibility that some of these insurers may receive downgrades in their credit ratings. Historically, the major bond insurers have been "AAA" rated entities. The possibility that some bond insurers may be downgraded has made auction rate security market bond holders more concerned about the credit worthiness, and consequently the liquidity, of their bonds. This is especially critical since, as noted below, the bond holders can't tender the bonds prior to maturity.

In order to mitigate the adverse consequences of the rising variable interest rates paid by the University on the bonds within the auction rate securities market, the Administration is evaluating the following alternatives:

1. One alternative would be for the University to convert these bonds over from the auction rate securities market to the variable rate demand bond market. Because of the nature of the variable rate demand bond provisions (which provides the bondholder with the right to tender the bonds for purchase prior to maturity), the presence of liquidity support from a financial institution is required. In short, the financial institution will step in as a buyer of the variable rate demand bonds if no other investors purchase the bonds through the remarketing process. Due to the liquidity feature in the variable rate demand bond market, the University should be able to mitigate the interest rate increases that are due to the unique circumstances impacting interest rates in the auction rate securities market. This change from auction rate security bonds to variable rate demand bonds merely represents a change in the mode within which the bonds were issued. However, the University must go through a process similar to issuing new bonds, including the preparation of an official bond statement, credit rating agency review, etc.

2. The other alternative would be to replace the existing bonds with traditional natural fixed rate bonds. Like a conversion to variable rate demand bonds described above, the University must go through a process similar to issuing new bonds, including the preparation of an official bond statement, credit rating agency review, etc.

There are some transaction costs associated with implementing either of these alternatives. These costs would be added to the outstanding bonds. We believe that implementation of either of these alternatives would have a relatively minimal impact on the existing annual University debt service payments. However, by incurring these transaction costs, the University would be able to likely avoid significant increases in its bonded interest rate costs that could occur because of rising interest rates in the auction rate securities market.

Over the next month, the University will analyze all possible alternatives, with a primary focus on the two alternatives discussed above. As part of this process, the University will issue a request for proposal for financial institution liquidity providers to submit liquidity pricing for a possible conversion to variable rate demand bonds. Subject to the request for proposal responses, and developments over the next few months in the general financial market, municipal bond market and with the bond insurers, evaluation of the costs, benefits and risks of the alternatives, it is very likely that the Administration will implement one of the two alternatives discussed above. An update regarding this matter will be provided at the March 19, 2008 Budget and Finance Committee meeting.