Variable Rate Demand Obligations (VRDO) Secured by Letter of Credits (LOCs)

Advanced Bond Finance Course

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Variable Rate Demand Obligations (VRDO) Secured by LOCs

- Variable Rate Demand Obligations are long-term bonds with short-term interest rates.
- The short-term interest rates, for example, may be reset daily or weekly (so-called "low floaters") by dealers on behalf of issuers. These dealers are called " remarketing agents"
- Annual Remarketing Agent fees are generally 0.125%.

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- From May 1998 to May 2008, the 15-year SIFMA average rate was 2.86%. The January 11, 09 rate was .46%. The 52-week running average as of 1/7/09 was 2.19%. The Securities Industry Financial Markets Association (SIFMA) swap index is a weighted average pool of high-grade tax-exempt bonds with weekly interest rate resets. Qualified Small Issues may trade 10-20 basis points higher than the SIFMA Index due to their small size and the fact they are AMT bonds. See: http://www.sifma.net/swapdata.html

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- VRDO bonds are reset based on comparable bond yields with similar credit enhancement and maturity.
- A major liquidity feature of VRDOs is the presence of “put” or “tender” features that allow bondholders to sell their bonds at par on a periodic basis. A bondholder may put bonds to the remarketing agent after a specific amount of advance notice such as 7 or 30 days, meaning the bondholder requires the remarketing agent to buyback their bonds at par.

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- Typically, the remarketing agent is able to sell the “put” bonds to someone else because they are priced to market at each interest reset.
- If the “put” bonds can not be sold to someone else (this is a very rare occurrence), then the Letter of Credit bank, who is providing a “liquidity” facility for the issue, must step up and buy the put bonds, which makes the bondholder whole.

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- The LOC or Standby Bond Purchase Agreement (SBPA) provided by the LOC bank provides a guarantee to bond holders against a failed remarketing.
- In the case of small issue bonds for manufacturers, as well as other bonds, the LOC bank may also provide credit support for the issue, meaning if the borrower is unable to make debt service payments the LOC bank will.

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- These are "direct pay" LOC under which the LOC bank actually makes debt service payments (called "draws" on the LOC) and the borrower is then required to immediately reimburse those draws. LOC fees have recently increased but historically for Small Issue borrowers fees have ranged from about 50-200 basis points annually .

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- If a borrower does not reimburse draws, the reimbursement agreements spells out what happens next-- typically, an unreimbursed draw may be termed out for five years at the banks prime lending rate.

- If the borrower is still unable to make payments, the bond issue may be collapsed with the LOC bank paying-off bond holders and then trying to recover its money from the borrower, sometimes in bankruptcy proceedings.

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- VRDO bonds also give borrowers the flexibility to call bonds in whole or party with sufficient notice to the trustee, such as 30-45 days.
- An important document in these transactions is the "reimbursement agreement" between the borrower and LOC bank. This agreement typically contains provisions indicating how bonds will be amortized and draws under the LOC for: interest, principal, liquidity, etc.

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- Some Qualified Small Issues are structured with 20-30 bullet maturities but the reimbursement agreement may require 15-year amortization. The ability of borrowers to call bonds without penalty makes this structure possible, which gives a LOC bank more flexibility if a borrower runs into financial difficulty.

- During 08, many more VRDO bonds issued, secured by LOCs, as auction-rate borrowers scrambled to convert their ARS to other interest rate modes.

Advantages of VRDO Bonds

- Historically, the lowest cost of capital available (but annual LOC fee must be factored into cost).
- The ability to prepay bonds at any time without penalty.
- Annual LOC costs are calculated on outstanding balance not original amount.
- No continuing disclosure to public.
- Ability to swap for fixed rates that might otherwise be higher.

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Disadvantages and risks of VRDO Bonds

- Interest rate risk.
- LOC/Liquidity Facility renewal risk (availability and price)—most have initial terms of only 1-5 years.
- IF LOC bank is downgraded, the bonds may trade at a higher spread to SIFMA.
- Remarketing risks (failed remarketing)—unusual but it happens.