TREASURY BOARD INTEREST RATE RISK MANAGEMENT GUIDELINES DATED May 18, 2005

1) Authority

These Guidelines are promulgated under the authority of § 2.2-2416 (8) of the *Code of Virginia* which empowers the Treasury Board to "establish debt structuring guidelines for bonds or other financing arrangements executed by or for the benefit of all state agencies, institutions, boards, and authorities where the debt service payments on such bonds or other financing arrangements are expected to be made, in whole or in part, directly or indirectly, from appropriations of the Commonwealth…"

2) Purpose

Variable rate securities are increasingly popular among issuers. While there are many reasons to embark on a variable rate program (interest rate savings, diversity of debt portfolio, asset/liability management to name a few), such a program exposes the issuer to risks different than those typically present in traditional fixed rate securities. The purpose of these Guidelines is to help issuers identify the risks and develop plans to manage and mitigate their exposure to such risks.

1) Policy

Because the management of variable rate debt can be complex and critical, issuers should adopt policies/guidelines and procedures to identify and control the amount of risk exposure. The policy should cover the following items:

a) Identify how the variable rate debt fits into the overall debt management plan.
   i) Establish parameters/capacity for variable rate exposure based on, for example, one or more of the following:
      (1) Dollar limit.
      (2) Maximum percentage of variable rate to total debt (e.g., 20%), revenues or other appropriate measure.
      (3) Percentage of short-term investments.
      (4) Identify methodology for calculating exposure.
   ii) Identify the types of variable rate exposure the entity willing to undertake (e.g., variable rate demand bonds, commercial paper, auction rate securities, etc.).
   iii) Explain the method and rationale for selected required professionals (e.g., dealer/remarketing agent, liquidity facility, etc.)
   iv) Rationale/Expected benefit. Benefits may include one or more of the following:
      (1) Asset/Liability management – match debt to asset useful life (i.e., use only for short term assets).
      (2) Asset/Liability Management – match with investment portfolio (i.e., liability in similar mode as investments.
      (3) Achieve interest rate savings by issuing at short end of the yield curve.
      (4) Provide flexibility in principal amortization/prepayment.
      (5) Diversification of investors – appeal to different investor base.
      (6) Adopt a portfolio approach to debt to diversify exposure.

b) Identify risks and develop plans, thresholds and/or strategies for dealing with the risks. Among them are:

    i) Interest rate risk
    ii) Liquidity risk
    iii) Rollover risk
c) Establish the mode (e.g., direct pay, standby) of the credit facility and minimal credit ratings for liquidity providers.
d) Establish plan/procedure for periodically monitoring and reporting on variable rate exposure to governing body.
    i) Determine break-even rate, feasibility rate (i.e., cost at which project not longer feasible).
    ii) At what point to terminate/convert?
e) Identify methodology for budgeting to address interest rate fluctuations (e.g., budget at fixed, establish reserve with "savings", purchase cap, etc.) and whether caps or other derivatives will be used in an effort to control risks.

3) Definitions:

a) Auction Rate Securities – Long-term, variable rate bonds tied to short-term interest rates. Traded at Dutch auction process. Auctions are held every 7,28, or 35 days, as specified. Investors submit bids through a broker/dealer to an auction agent. The winning bid rate is the rate at which the auction clears (i.e., the lowest rate that equals the total securities demanded (buyers) to the amount auctioned (sellers). All bids receive the same rate. Primary investors are corporate cash managers and high net worth individuals. No liquidity facility is required, but most carry bond insurance.
b) Liquidity Facility – Typically a bank contracted to temporarily act as owner of the bonds in the event that holders tender the bonds back to the issuer or the issue cannot be successfully remarketed on a tender or remarketing date.
c) Variable Rate Demand Bonds (VRDBs) – Bonds with a nominal long-term maturity, with a coupon that is adjusted weekly (or other interval). Their high degree of liquidity is derived from a put feature that allows investors to sell (put) the bonds back to the issuer at any interest payment date at par. This feature permits investment by tax exempt money market funds that otherwise would be unable to invest in bonds. VRDBs require a standby bond purchase agreement from a commercial bank in the event bonds cannot be successfully remarketing to investors.