VIRGINIA COLLEGE BUILDING AUTHORITY
VARIABLE RATE DEBT POLICY
Adopted 9/15/05

I. Purpose

Variable rate debt and interest rate swaps can be valuable tools for the Authority to use in the management of its liabilities, serving to reduce interest costs and increase flexibility. However there are risks that the Authority should consider. This policy relates to interest rate exposure that may be undertaken by the Authority under the provisions of §23-30.28 and §2.2-4517 of the Code of Virginia, and shall be used by the Authority in determining under what circumstances it may be appropriate to engage in interest rate management techniques and to manage its interest rate exposure.

II. Rationale

There are numerous reasons for an issuer to consider the use of variable rate securities and/or interest rate swaps. Chief among them is the opportunity to:

- Reduce borrowing costs.

Other reasons may include:

- Asset / Liability Management – match debt to investment portfolio
- Flexibility in principal amortization and/or prepayment
- Diversification of investors (e.g., money market funds)
- Diversification of liabilities – a portfolio approach to debt management
- Achieve refunding savings not otherwise achievable

The Authority's primary objectives in utilizing such instruments are:

- Diversification of interest rate exposure; and
- Reduction of borrowing costs.

The Authority's Financial Advisors have articulated the benefits of a portfolio approach to debt management including the reduction in exposure to any one type of interest rate movement or yield curve change that would create actual or opportunity cost dissavings when compared to a portfolio approach.

However the Authority does not necessarily propose to pursue a policy of debt portfolio diversification without consideration of the second objective of reducing borrowing costs.

In the consideration of anticipated lower borrowing costs, the Authority will consider (i) the expected annual Net Present Value (NPV) savings over the expected life of the issue (including anticipated fees and other costs), (ii) circumstances under which the issue reaches the "breakeven" point (i.e., the rate at which the cost of a variable issue will exceed the cost of a comparable fixed rate issue), and whether undertaking the interest rate exposure is appropriate given the expected savings.

III.Risks

The Authority recognizes that variable rate exposure carries inherent risks not present in traditional fixed-rate transactions. Among them are:

- Interest rate risk – The risk that interest rates will, on a sustained basis, rise above levels that would have been attained had the issue been issued at a fixed rate.
- Liquidity risk – The risk of having to pay a higher interest rate to the liquidity facility (or if self-liquidity, of having the draw against current funds) in the event of a failed remarketing.
- Rollover risk – The risk of the inability to obtain a suitable liquidity facility at an acceptable price to replace a facility upon termination or completion of contract period.
- To the extent that the variable exposure is achieved through interest rate swaps, additional risks are imposed (see section X).

IV. Exposure Limits

The Authority determines that variable rate exposure will not exceed 20% of its outstanding debt. This calculation will be made prior to incurring any additional variable rate exposure and at least annually at the end of each fiscal year. The following will be included in the calculation:

- the outstanding principal amount of debt issued or outstanding as direct variable rate bonds, auction rate securities and commercial paper, or any other instrument for which the next interest reset date is less than 365 days, and
- the notional value of any exchange contract on which the Authority will pay a variable rate of interest (e.g., a swap),

LESS the amount of direct variable rate debt for which variable rate exposure has been eliminated or reduced by interest rate exchange agreements (swaps) or interest rate caps, collars or other hedging mechanism, for the duration of the hedging agreement (e.g., a five year cap only excludes those five years of exposure)

The calculation will NOT include the notional value of an exchange contract (swap) on which the Authority will receive a variable rate of interest, when the intention is the creation of synthetic fixed rate debt.

V. Variable Rate Instruments

Variable rate debt may include Auction Rate Securities, Variable Rate Demand Bonds (VRDBs), commercial paper or synthetic floating rate debt (i.e., swaps). Decisions about which mode of variable rate debt to incur at any point in time will be based the relative costs, benefits and risks to the Authority and the Commonwealth. Factors that will be considered will include:

- Cost and availability of liquidity facilities (i.e., standby bond purchase agreements, lines of credit, etc. necessary for the issuance of VRDBs and commercial paper).

- Cost to implement and manage the program on an on-going basis.
- Ability to convert to different mode.
- Demand in the market.
- Degree of exposure to risks beyond interest rate exposure (e.g., counterparty risk, termination risk, basis risk, liquidity/remarketing risk).

VI. Structuring the Transaction

- VRDBs and Auction Rate Securities will be structured so as to provide for principal amortization at least annually (except as may be delayed during construction periods or to coincide with existing bond amortization).
- Requests for debt service appropriations will be at an assumed fixed rate of interest, which will be evaluated and adjusted as required to reflect current projected market rates.
- The Authority's variable rate exposure may, at the time of issuance or subsequently, be hedged by the use of caps, collars or swaps.
- In the case of Swaps, a standard market index will be employed (e.g., BMA, LIBOR). See Section X for additional Swap guidelines.
- Liquidity may be provided through a direct-pay or stand-by bond purchase agreement, line of credit, letter of credit, or self-liquidity (only as may be determined by the State Treasurer), or other method as may be suitable given the underlying bond rating and the structure of the transaction.
- Bank liquidity facilities will carry minimum short-term rating of A-1/P-1 unless the transaction is collateralized (in the case of swaps). In the event any liquidity facilities are downgraded below minimum limits, the Authority will endeavor to replace the liquidity facility within a reasonable time period.
- The Authority will consider other factors beyond credit rating when selecting liquidity facilities, including: trading values (market acceptance of the provider), cost (including the interest rate to be charged in the event of a draw against the facility), term of coverage offered, documentation requirements, flexibility, etc.

VII. Selection of Professionals

The Authority will select any professionals required in undertaking a variable rate transaction (including dealers, remarketing agents, liquidity facilities, auction agents, etc.) through a competitive process in accordance with state procurement policy. The Authority may utilize any pooled procurements to which it is eligible (e.g., the Treasury Board/Department of the Treasury may procure a blanket liquidity facility available to certain Commonwealth credits) that will achieve cost reductions.

VIII. Action by the Authority

The Authority will evidence its approval of the issuance of variable rate obligations, interest rate exchange agreements, swaps or other ancillary contracts, by a resolution.

IX. On-going Monitoring and Reporting

As often as necessary, but no less than twice each year, staff to the authority will analyze the historic and projected performance of any variable rate or interest rate swap exposure and present the findings and recommendations to the State Treasurer. The Authority will be presented with the analysis at the earlier of its next regularly scheduled board meeting or by mail within 30 days. Such recommendations will include a determination as to whether the transaction is performing in a satisfactory manner and if not, a recommended exit strategy.

X. Ancillary Contracts

This section sets the Authority's policy as it relates to ancillary contracts, which may be entered into simultaneously or subsequently to any related fixed or variable rate transaction.

1. Permitted Instruments - The Authority may enter into
   - interest rate swap agreements, fixed or floating,
   - interest rate caps, collars or floors.

   The Authority will not enter into ancillary contracts for speculative purposes, including basis swaps.

2. Risks - The Authority recognizes that these transactions carry the additional risks, which are defined herein:
   - Counterparty risk - The risk that the other party in the derivative transaction fails to meet its obligations under the contract.
   - Rollover risk - The risk that swap contract is not coterminous with the related bonds. In the case of the synthetic fixed rate debt structure, rollover risk means that the Authority would need to re-hedge its variable rate debt exposure upon swap maturity and incur re-hedging costs.
   - Basis risk - Movement in the underlying variable rate indices may not be perfectly in tandem, creating a cost differential that could result in a net cash outflow from the Authority. Basis risk is also the mismatch that can occur in a swap with both sides using floating rates, but different, indices.
   - Tax event risk - The risk stemming from changes in marginal income tax rates due to the tax code's impact on the trading value of tax-exempt bonds. A form of basis risk.
   - Amortization risk - The cost to the Authority of servicing debt or honoring swap payments due to a mismatch between bonds and the notional amount of swap outstanding.

- Termination risk -The risk that a swap will be terminated by the counterparty before maturity that could require the issuer to make a cash termination payment to the counterparty. Note: the issuer could have a termination payment even if the termination results from counterparty default.

3. Rationale - Swaps, interest rate exchange agreements, or other ancillary contracts (e.g., caps, collars, floors) will not be entered into for speculative purposes. The Authority may authorize entering into a swap if it is reasonably determined that the transaction is expected to:
    - Achieve an overall lower cost of funds (net of fees) compared to a product available on the bond market
    - Prudently hedge interest rate risk
    - Synthetically advance refund bond issues
    - Increase flexibility
    - Achieve appropriate asset/liability match

    In connection with any swap, the Authority and its financial advisor will review the proposed transaction including the following:
    - Identify the potential benefits versus potential risks
    - Conduct and independent analysis of the fair market value of the proposed agreement
    - Costs of remarketing, credit enhancement, liquidity fees, ratings fees and other on-going costs.
    - Interest rate swaps used to synthetically advance refund an issue should generate measurably greater projected savings than the savings guidelines the Authority would consider for traditional refunding bonds unless the refunding transaction could not be achieved through more traditional means.
    - Counterparty exposure.

4. Documentation – The Authority will use standard ISDA swap documents. Authority swap documentation should include the following:
    - Swap Term – The Authority will determine the term of any swap agreement on a case-by-case basis with due consideration of all relevant factions including optional redemption/call dates of any related debt issue. No swap agreement will extend beyond the final maturity date of the related bonds.
    - Provisions in the event of downgrade of either the related debt or the swap counterparty. The specific indebtedness related to a credit event should be narrowly defined.
    - Authorizing resolution will include a delegation provision as detailed below.
    - Swap agreements will not become effective unless and until the related bonds have been delivered.

5. Counterparties
    - Qualifications – Qualified counterparties will have (i) demonstrated experience in successfully executing interest rate exchange contracts with other governmental entities, (ii) a credit rating by at least two nationally recognized rating agencies in the AA category, or its payments are unconditionally guaranteed by an entity with credit ratings meeting this criteria. The Authority may utilize a counterparty that does not satisfy the rating criteria provided that the counterparty post and maintain collateral as set out below.
    - Selection – A competitive bid process will be used to select swap counterparties unless the complexity, size or needed proprietary information warrants otherwise.
    - Collateral - Collateral will be in the form of USD cash, US Treasury securities, or agency securities guaranteed by the Treasury, at a level of at least 100% of the net market value of the exchange agreement, taking into account the collateral duration. Collateral will be maintained with a mutually agreeable third party or trustee, and will be marked to market by the agent or trustee daily. Collateral will be provided in a manner satisfactory to the Authority so that its interests are (i) protected, (ii) not a matter of preference, and (iii) not subject to stay in the event of bankruptcy of the counterparty.
    - Counterparty Exposure/Diversification – No single counterparty (or guarantor thereof) will carry more than 15% of the Authority's computed swap exposure, or $100 million, whichever is greater. In determining counterparty exposure, consideration may be given to Commonwealth exposure to the same corporate entities through other financial arrangements. In the event the Authority deems it desirable, exposure may exceed the limit, provided the excess amount is fully collateralized.

6. Termination/Transfer – All swap transactions will allow the Authority the right to optionally terminate or transfer the swap agreement at any time over the term of the agreement. Exercising the right to terminate should produce a benefit to the Authority or the Commonwealth (e.g., through the receipt of payment from the counterparty, cost or risk avoidance or ability to convert to a more beneficial arrangement).

7. Reporting – A written report providing the status of all interest rate swap agreements will be provided to the Treasury Board by the Authority with a mailed copy to the Authority's board. Such reports may be prepared by the Authority, financial advisor, swap counterparties, and/or swap advisor on a quarterly basis. The report will include:
    - A description of all outstanding interest rate swap agreements, including related bond series, type of swap, rates paid and received by the Authority, total notional amount, average life, remaining term.
    - Current market value of the swap agreement.

- Highlights of all material changes to the swap agreements or new agreements entered into since the last report.
- Termination exposure under each swap agreement.
- Credit rating of each counterparty.
- Summary of terminated or expired agreements.
- Any other reporting information necessary for compliance with the Financial Accounting Standards Board (FASB) Statement 133.

8. Delegation/Ongoing Management – The Authority will actively manage its swap program to maximize benefits and minimize risks. The Authority delegates to the State Treasurer the authority to (i) terminate, (ii) require posting of additional collateral, or (iii) otherwise act on behalf of the Authority in the event a situation arises which, as the sole discretion of the State Treasurer, warrants immediate action to mitigate, limit or eliminate risk to the Authority or the Commonwealth.

XI. Definitions

Amortization risk	The cost to the issuer of servicing debt or honoring swap payments due to a mismatch between bonds and the notional amount of swap outstanding.
Auction Rate Securities	(“ARS”) Long-term, variable-rate bonds tied to short-term interest rates. Interest rates are reset through a modified Dutch auction process (typically every 7, 28, or 35 days) where securities are sold at the highest price as which sufficient bids are received to sell all the securities offered. ARS trade at par and are callable on any interest payment date. They do not have a put feature and therefore do not require liquidity facility.
Basis risk	Movement in the underlying variable rate indices may not be perfectly in tandem, creating a cost differential that could result in a net cash outflow from the issuer. Basis risk is also the mismatch that can occur in a swap with both sides using floating rates, but different, indices.
Basis swap	A swap agreement in which the issuer pays a amount based on one index (e.g., BMA) while receiving an amount based on another index (e.g., LIBOR), plus a spread. The transaction is based on the ratio between BMA and LIBOR over time.
BMA Index	The Bond Market Association Municipal Swap Index, the principal benchmark for the floating rate payments for tax-exempt issuers. The index is a national rate based on a market basket of high-grade, seven-day tax-exempt variable rate bond issues.
Counterparty	The financial institution with which the issuer enters an interest rate exchange agreement
Counterparty risk	The risk that the other party in the derivative transaction fails to meet its obligations under the contract.
Derivative	A financial transaction “derived” from an underlying asset, debt, index or reference rate.

Direct Pay Letter of Credit	Pays the investor with cash directly rather than at the direction of the state (i.e., as opposed to stand-by arrangement).
Hedge	A transaction entered into to reduce exposure to market fluctuations.
Interest rate swap	A transaction in which two parties agree to exchange future net cash flows based on predetermined interest rate indices calculated on an agreed notional amount. The swap is not a debt instrument between the issuer and the counterparty, and there is no exchange of principal.
ISDA	International Swap Dealers Association.
ISDA Master Agreement	The standardized master agreement for all swaps between the Issuer and the dealer that identifies the definitions and terms governing the swap transaction.
Liquidity Facility	A bank or other financial firm, as liquidity facility provider, to temporarily act as owner of bonds (i.e., buy the bonds) in the event that holders tender bonds back to the issuer and the bonds cannot be successfully remarketed.
Long-dated swap	A swap with a term of more than ten years. Often used in the municipal market, as issuers often prefer to use a hedge that matches the maturity of the underlying debt or investment.
LIBOR	The principal benchmark for floating rate payments for taxable issuers. The London Inter Bank Offer Rate is calculated as the average interest rate on Eurodollars traded between banks in London and can vary depending upon maturity (e.g., one month or six months).
Mark-to-market	A calculation of the value of a financial instrument (like an interest rate swap) based on the current market rates or prices of the underlying index (i.e., the variable on which the derivative is based).
Notional Amount	Principal amount on which exchange contract interest is calculated.
Remarketing Agent	An underwriting firm selected to periodically remarket VRDBs to investors.
Rollover risk	The risk that a swap maturity contract is not coterminous with the related bonds. In the case of the synthetic fixed rate debt structure, rollover risk means that the issuer would need to re-hedge its variable rate debt exposure upon swap maturity and incur re-hedging costs. In the case of a liquidity facility, the risk of being unable to obtain a suitable replacement liquidity facility at a reasonable price upon completion or termination of a contract period.
Standby Letter of Credit	Any facility where bank or other provider stands ready to provide funds as and when needed.
Swap	A derivative that alters the cash flows of a debt obligation. An issuer's exposure to increasing interest rates arising from variable-rate debt may be hedged through a swap.
Swaption	(known also as "swap option") A derivative that grants one counterparty the option to begin, cancel or extend a swap.

Tax event risk	The risk stemming from changes in marginal income tax rates due to the tax code's impact on the trading value of tax-exempt bonds. A form of basis risk.
Termination risk	The risk that a swap will be terminated by the counterparty before maturity that could require the issuer to make a cash termination payment to the counterparty. Note: the issuer could have a termination payment even if the termination results from counterparty default.
VRDB	Variable rate demand bonds. A long-term bond for which the interest rate is reset periodically through a remarketing process. Bondholders have the option to "put" or "tender" the bond back to the issuer typically at interest reset dates. The put feature makes VRDBs an eligible investment for money market funds. VRDBs require a liquidity facility in case of failed remarketing.