Investment Committee Memorandum
Board of Regents, State of Iowa

Subject: Variable and Fixed Rate Bonds

Prepared by: Joan Racki

Date Submitted: December 1, 2004

Recommended Action:

Receive the report on variable and fixed rate bonds presented by Barry Fick of Springsted, Inc., the Board's financial advisor.

Executive Summary:

At its November 2004 meeting, the University of Iowa Hospitals and Clinics Executive Board Committee requested that the Board's Investment Committee receive a report on variable and fixed rate bonds at its December 2004 meeting.

Barry Fick of Springsted, Inc., the Board's financial advisor, will make the presentation, a copy of which is attached to this memorandum.

Presentation to the

Board of Regents, State of Iowa

Investment Committee

December 2004

Fixed / Variable Debt Options

Presenter: *Barry W. Fick*
Senior Vice President
Springsted Incorporated

SPRINGSTED
Public Finance Advisors

Debt Issue Options

- Fixed Rate Debt
  - Interest rates are set at the time the Bonds are originally issued
  - Usually sold using competitive bid sale process
- Variable Rate Debt
  - Interest rates change periodically, generally weekly or daily
  - Must be sold using negotiated sale process
- Combination
  - Multiple series of Bonds for a given project may be issued, some may be variable and some may be fixed rate bonds

Debt Issue Options

- Common Rules for tax exempt bonds are applicable to all financings, whether fixed or variable rate

- Treasury Department Requirements
  - Proceeds spend down requirements
  - Arbitrage limitations
- State requirements
  - Interest rate mitigation restrictions
  - Bond structure limitations (maturity, principal amortization, etc)
- Other limitations
  - Market preference
  - External factors affecting debt market (financial, economic)

Debt Issue Options

- Additional items required for Variable Rate Bonds

- Must be sold using negotiated sale process
  - Request for proposal process to select underwriter/remarketing firm necessary
  - Selection of remarketing agent tied to underwriter selection
- Additional parties involved in transaction
  - Liquidity provider (if self-liquidity not used)
  - Liquidity counsel
- Additional administrative tasks required during life of bonds
  - Monitor interest rates (performed by Springsted @ no cost)
  - Change remarketing agents if needed due to poor rate resets

Fixed Rate Debt

Advantages

- Avoids the risk that interest rates will increase in the future and increase the cost of debt
- Once in place, fixed interest rates do not change
- Ability to call outstanding debt after 9-10 years with no pre-payment penalty
- Ease of budgeting, you know in advance what the annual debt service payment will be
- Ability to lock-in current low rates
  (see chart on last page)

Fixed Rate Debt

Challenges

- Reduced repayment flexibility. Industry standard is to have no redemption provision before 9 or 10 years unless an advance refunding is undertaken
- May be difficult or impossible to take advantage of lower future interest rates due to the reduced ability to refinance (only one advance refunding is allowed under federal rules)
- Could constrain future borrowing capacity if you can’t refund and restructure existing debt
- Interest earned on debt service reserve fund may be lower than interest paid on bonds – negative arbitrage

Variable Rate Debt

Advantages

- Lower cost of borrowing. Historically, short-term rates have consistently been lower than fixed rates
- Greater flexibility - ability to prepay at short notice without penalty
- Access to risk management tools to mitigate interest rate risk (subject to State Regulations)
- Capability to convert to fixed rate
- Capacity to manage balance sheet by matching short-term investments with short term debt
- Greater ability to integrate future debt financing

Variable Rate Debt

Challenges

- Exposure to increases in interest rates
  - Risk of sustained and continuing high level of interest rates
- Liquidity risk - short call notice held by bond holders
  - Risk that credit provider may fail to make payment
  - Risk of insufficient funds or lack of timely receipt of funds
- Fluctuating debt service payments make budgeting difficult
- Letter of credit renewal risk
  - Need to find new Liquidity provider
  - Unexpected redemption if liquidity is uncertain
  - Higher cost on renewal with current or new liquidity provider

Variable Rate Debt

Interest Rate Re-Set Options

- Daily - interest rate is reset every business day
- Weekly - interest rate is reset weekly
- Other - interest rate reset period can be monthly, quarterly or whatever fits your needs

Variable Rate Debt

Credit Enhancement

- Letter of Credit provided by bank provides the strongest credit support. This is the most costly direct payment credit support option. Often requires amortization of principal.

- Standby Bond Purchase Agreement provides credit support under specific circumstances. Works best where the credit of the issuer is strong. This costs significantly less than a full Letter of Credit.

- Self-Liquidity. The borrower sets aside 120%-140% of the par amount of the debt to provide security. The funds set aside are usually U.S. Treasury securities. This can have restrictive consequences for investment earnings and portfolio management, but is a good option if investment policy allows for short-term qualifying securities to provide self-liquidity.

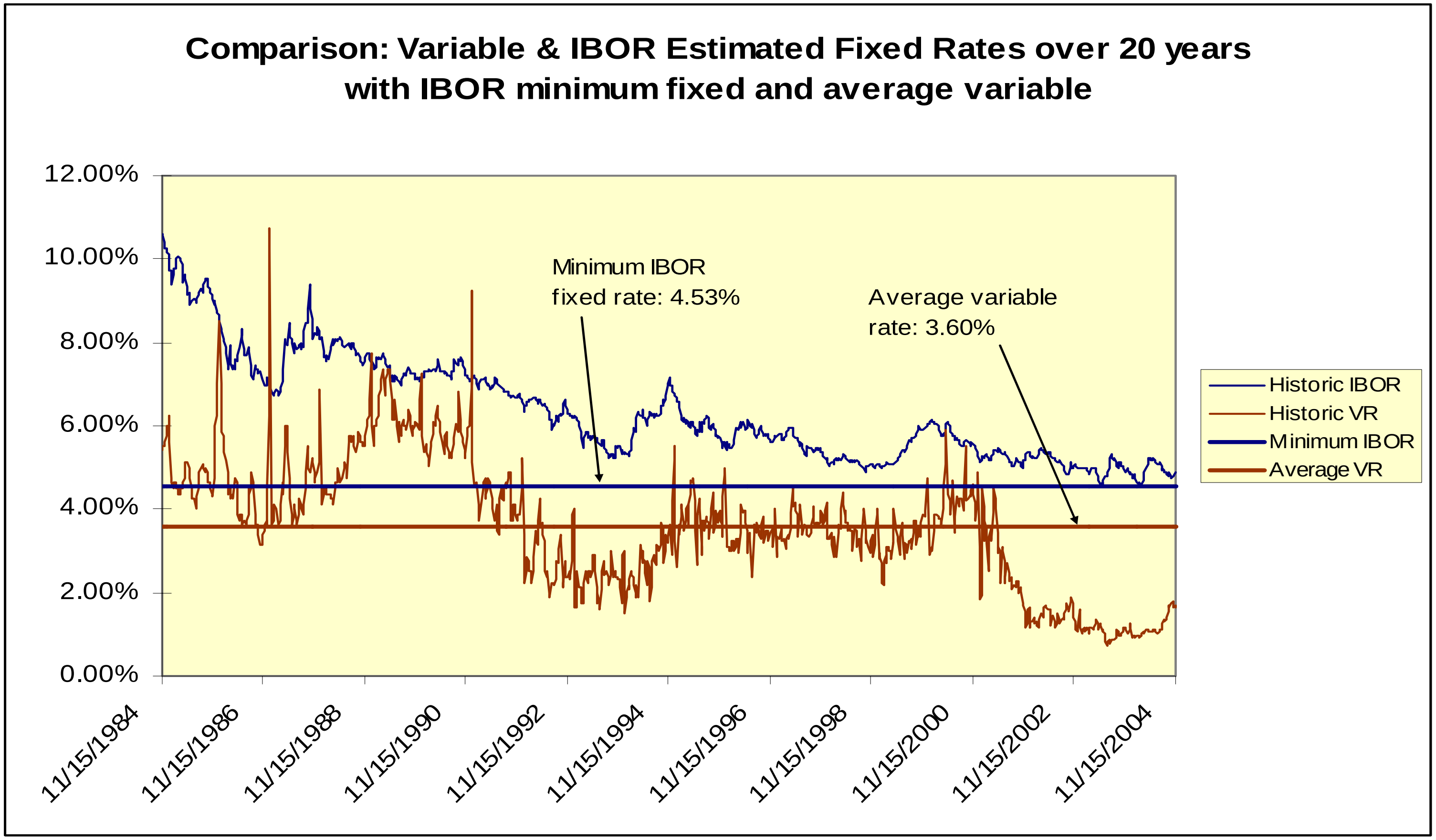
BMA Index

- The tax-exempt floating rate paid on the bonds is assumed to be equal to the BMA Index. The BMA index creates the most efficient proxy rate for tax-exempt financing
- BMA is a weekly high-grade market index comprised of 7-day tax-exempt variable rate demand notes produced by Municipal Market Data
- It is important to note: Each reset of the BMA Index may vary slightly from the actual reset on the bonds

Discussion Points

- Single issue or multiple issues?
  - Single set of documents
  - Single issue reduces time, administrative effort and cost
  - Maximizes time to invest construction proceeds
  - Avoid future fixed interest rate increases
  - IRS issues – arbitrage limits, spending requirements, premature issuance restraints

- Why not take advantage of low fixed rates in current market?
  - Variable rates below fixed rates in most markets regardless of absolute level
  - Highest variable rates below lowest fixed rates


Comparison: Variable & IBOR Estimated Fixed Rates over 20 years
with IBOR minimum fixed and average variable
12.00%
10.00%
8.00%
6.00%
4.00%
2.00%
0.00%
Minimum IBOR
fixed rate: 4.53%
Average variable
rate: 3.60%
11/15/1984
11/15/1986
11/15/1988
11/15/1990
11/15/1992
11/15/1994
11/15/1996
11/15/1998
11/15/2000
11/15/2002
11/15/2004
Historic IBOR
Historic VR
Minimum IBOR
Average VR