Legislative Fiscal Bureau
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Agreements Related to State Borrowing Programs (Building Commission)

Bill Agency

[LFB 2007-09 Budget Summary: Page 69, #2]

CURRENT LAW

The Building Commission has the authority to issue general and revenue obligation debt on behalf of the state. The Commission can enter into certain agreements and ancillary arrangements relating to issuance of state general obligation debt and operating notes.

The Building Commission has broader authority to enter into agreements and ancillary arrangements relating to issuance of state revenue obligation bonds and appropriation obligation bonds at the time of, or in anticipation of, or after issuing such debt.

GOVERNOR

Modify the state's the state's debt obligations to allow the Department of Administration (DOA), or the Building Commission and DOA Capital Finance staff, to enter into certain interest rate exchange agreements associated with these debt programs with a third party.

Institute certain reporting requirements and guidelines for interest rate exchange agreements related to state's general obligation debt. Specify that certain types of agreements related to state's general obligations and appropriation obligation borrowing programs would be subject to Joint Committee on Finance approval.

The entire summary of the Governor's proposed modifications to state borrowing programs is provided in the attachment to this paper.

DISCUSSION POINTS

Background

1. Since 1969, the Building Commission has been authorized to issue state debt, including the refunding of such debt for refinancing purposes. Each bond issue involves a series of bonds with specific rates and maturities. Occasionally, the state refinances its debt by issuing refunding bonds and replacing an existing stream of debt service payments with an alternative stream of payments when rates are favorable. Typically, the new stream of debt service payments is designed to reduce the interest costs on the outstanding debt by taking advantage of lower current interest rates. Generally, if the present value of the savings from a potential refunding exceeds 3% of the amount to be refunded, the state will carry out the refunding.

2. Another way the state currently refunds state debt is through advanced refundings, which typically involve refunding callable bonds prior to their call date. Under this type of refunding transaction, a separate set of bonds is issued at rates that are lower than the rates on the existing bonds that are being advance refunded. The proceeds of these bonds are placed in investments within an escrow account, from which the principal and interest payments on the existing bonds are made until the call date, at which time the escrow pays off the bonds. The state then repays the lower cost bonds, which results in interest costs savings to the state. However, federal tax law allows only one advanced refunding of tax exempt bond issues.

3. The provisions in the bill would create additional means within the municipal debt market for the state to lower its overall financing costs without carrying out a refinancing. Based on information from DOA, these modifications would allow the state, and a third party, to enter into certain interest rate exchange agreements associated with the state's debt obligations. These agreements could be entered into at the time that state debt obligations are issued or any time such issues remain outstanding. The agreements, or "swaps," are considered a debt management tool that can provide a debt issuer certain benefits, such as reducing its exposure to interest rate volatility, reducing its cost of capital, and increasing its flexibility to alter the structure of its existing debt payments. In using this authority, DOA and the Building Commission would have the responsibility of balancing these potential benefits with the inherent risks associated with entering into the types of agreements or arrangements that would be authorized under the bill.

4. An interest rate exchange agreement or swap is a contractual agreement between two parties who agree to exchange certain cash flows for a period of time. Generally, the cash flows to be swapped relate to interest to be paid or received with respect to some asset or liability of one of the parties to the agreement. The agreement is designed to generate a net change in the cash flow related to that asset or liability. For example, an agreement may be designed to effectively convert variable rate payments on existing obligations to fixed rate payments associated with those obligations, or vice versa. No principal amounts are exchanged and no new principal amounts are incurred. Rather, a hypothetical (or notional) principal amount is determined under the agreement, which becomes the base on which the swapped interest payments are calculated. Interest rate swap agreements do not typically generate new funding like bond sales; rather they effectively convert

one interest rate basis to a different basis, as the state has done under its current variable to fixed swap agreement associated with the state's unfunded prior service liabilities appropriation obligation bonds.

5. The market for swaps, derivatives, and hedging products dates back to the early 1980's. Since then, it has grown into a significant financial market for both private and public debt issuers. While the use of these products is widely prevalent among private issuers, governmental units have more recently become involved in the swap market as a method to refinance debt or hedge against changes in interest rates on fixed and variable rate debt.

On-Market versus Off-Market Swap Agreements

6. Typically, the state issues debt obligations to fund capital projects and other improvements for the state and local governments and to make state land purchases. Under the proposed modifications, the state would be acting somewhat as a financial investor by entering into agreements that would be ancillary to those state bond issues in an attempt to hedge against interest rate risk, realize cost savings in lieu of conventional refinancing, maintain flexibility, or capture some value relative to the bonds without refinancing those bonds.

7. There are two types of swap transactions the state would likely undertake using the authority provided under the bill. First, on-market agreements are transactions in which the parties effectively exchange market equivalent payment streams over the period of the agreement. Second, off-market agreements are transactions whereby one party agrees to make interest payments at a coupon rate that is above the market rate at the time of the agreement, or to receive payments based on a coupon rate that is below the market rate at the time of the agreement. In return, the party that agrees to make payments at rate that is above the market rate or receives payments at a rate that is below the market rate receives an upfront cash payment.

8. Under current law, DOA has the authority to enter into on-market transactions relative to the state's appropriation obligation and revenue obligation bond programs. However, DOA indicates that proposed statutory changes relative to the state's revenue obligation programs are needed to effectively carry out an on-market agreement associated those programs. The bill would also allow the Building Commission to enter into on-market agreements relative to the state general obligation and operating note programs.

9. DOA Capital Finance officials estimate that the state could receive $4,500,000 in 2007-08 by entering into "swap" agreements or arrangements associated with the state's general obligation bond debt. These moneys would offset GPR debt service for the purposes for which the initial bonds are sold. Because the specific bonds associated with these agreements or arrangements are not known, for the purposes of the state's general fund condition statement, the savings amounts would be considered to lapse from these GPR sum sufficient debt service appropriations. Similar receipts of payments related to agreements or ancillary arrangements related to state's appropriation and revenue obligation bond debt would accrue to those programs.

10. DOA used its existing authority to enter into swap agreement relative to the state's appropriation obligation program when the state issued those bonds refinance the state's unfunded pension and accumulated sick leave conversion liabilities. In structuring this debt, the state issued approximately $944.9 million in variable, or floating rate, taxable auction rate certificates (ARCs). The state then simultaneously entered into a floating-to-fixed interest rate swap agreement on a portion of these ARCs to receive a variable, floating rate payment and pay a fixed interest payment in order to hedge against the state's exposure to rising interest rates on this variable rate debt. Under the state's swap agreement, the state agreed to make interest payments based on a percentage of a fixed market rate at the time of the agreement on a $595 million notional principal amount of debt. In return, the state receives floating interest payments from the counterparty to the agreement that are calculated on the same $595 million notional principal amount. The goal is for the payments the state receives under the agreement to as closely as possible match the state's existing variable rate interest payments on the principal amount of ARCs. Therefore, under the agreement, the state has mitigated its exposure to variable rate risk associated with this variable rate debt, by effectively exchanging the variable rate debt for fixed.

11. DOA indicates that through March 1, 2007, the state has saved approximately $4.05 million associated with the on-market swap transaction associated with the state's appropriation obligation debt. The savings reflect the difference between the sum of the net fixed rate payments due from the state after fees and the amount of debt service that would have been due had the state issued the same amount of fixed rate bonds at the time the agreement was entered into. The state has benefited from the actual rate paid by the state on the ARCs has been on average less than the market index

12. During the 2005 legislative session, a similar legislative proposal would have authorized the Building Commission to enter into swap agreements related to state debt for the veterans mortgage home loan program. The current proposal would also extend this authority to the veterans loan program. With this authority in place, the state would have the ability make more use of short-term variable rate debt in the veterans mortgage loan program. Short-term variable rate financing could potentially reduce the costs on the loan program's taxable borrowing, which in turn, could reduce the blended financing costs to eligible veteran borrowers. This blended rate could allow the Department of Veterans Affairs loan programs to be more competitive with private lending institutions in the veterans home loan market. However, swap agreement authority is needed if the loan program is to make significant use of short-term, variable rate financing, in order to mitigate the loan program's exposure to short-term, variable interest rates, if such rates rise, while still allowing the program the benefits of using short-term borrowing.

13. Off-market swap agreements are termed off-market because one party agrees to make interest payments at a coupon rate that is above the market rate at the time of the agreement, or to receive payments based on a coupon rate that is below the market rate. In return, the party receiving payments at a below market rate receives an upfront cash payment. Under a 2005 legislative session proposal that was similar to the current proposal, DOA outlined an off-market agreement relating to the state's appropriation obligation debt. Under this example, in return for receiving an upfront payment, the state would have received floating interest payments on a notional

principal amount that is associated with a specified debt issue. The floating rate was based on a rate priced at 67% of a short-term variable market index, rather than receiving a market rate priced at 80% of the same index. Therefore, under this transaction, the state would have forgone higher annual interest payments in the future under the agreement, in return for the upfront funds.

14. State bond counsel believes that the proposed statutory language changes to the state's bonding programs are needed in order carry out off-market swap agreements relative to the state's appropriation obligation bonds. The bill would also allow the state to carry out these agreements under the state's general obligation, revenue obligation, and operating note borrowing programs. Specifically, bond counsel has indicated that before a positive opinion can be provided on the proposed swap agreement, statutory changes to require that the Building Commission or DOA include in an interest rate agreement a conclusion that such an agreement relates to a specific obligation.

15. While the payments on both an off-market agreement and an equivalent on-market agreement associated with the same notional principal amount may result in economically equivalent payments in present value terms, off-market swap agreements could be considered borrowing by the state. That is, the state would receive an upfront payment and then pay back the loan over time by receiving lesser annual payments under the proposed agreement. This transaction would not represent a refinancing of state's bonds. Instead, as part of the proposed swap agreement, the state would effectively borrow the upfront amount, and then repay that amount by accepting below market payments in future years.

16. One concern associated with authorizing off-market agreements would be that the administration or the Building Commission could generate current revenues in exchange for potentially higher future costs to the state. Some contend that such transactions would be no different than other state bonding in which the state receives bond proceeds today in exchange for a stream of future debt service payments. However, once the off-market swap agreement authority is provided by the Legislature, DOA and the Building Commission would not be limited by a statutory bonding authorization like they are under the state's bonding programs. Consequently, the Legislature would no longer have authority over the revenues and expenditures relative to these transactions.

17. In response to this concern, SB 40 would establish certain limitations on off-market agreements relative to the state's general obligation and appropriations obligation debt. Under the bill, DOA or the Building Commission would not be allowed to carry out an off-market interest rate exchange agreement unless DOA or the Building Commission, depending on the underlying debt obligation, provides written notice to the Joint Committee on Finance of its intention to enter into an agreement that is reasonably expected to be subject to the limitation on structuring interest rate agreements. Within 14 days of receiving the written notice from the Commission, the Committee would have to either approve or disapprove whether the Commission can enter into the off-market agreement.

18. The proposed limitations for off-market agreements would only apply to interest rate

exchange agreements on the state's general obligation and appropriation obligation debt programs. Therefore, the state's revenue obligation and operating notes programs would not be subject to limitations. In order to ensure oversight of off-market agreements related to these obligations, the Committee could make such agreements subject to the proposed off-market limitations.

19. Under the bill, DOA and the Building Commission would also be authorized to make expenditures from the state's GPR sum sufficient debt service appropriations for payments required under these agreements. This could be seen as a significant expansion of authority for the administration and the Building Commission relative to public debt issued by the state.

Potential Risks and Proposed Safeguards

20. While the specific proposal differs somewhat, the Governor has proposed similar expansions in DOA's and the Building Commission's authority related to agreements associated with state debt programs in each of the past two biennial budgets. In analyzing the prior proposals, this office identified the various risks associated with such transactions. For example, the success of the state in generating cost savings under these transactions would largely depend on the state's ability to accurately price and establish the terms of these transactions. In doing so, the state would need access to the best information available on the interest markets at the time of the transaction. If the pricing of the transaction or the terms established under the transaction are not sound, the transaction could end up increasing interest costs to the state. Finally, the lack of program guidelines, legislative oversight, and reporting requirements related to such transactions were also identified as concerns.

21. The risks associated with these transactions would continue to exist. However, the Governor and DOA Capital Finance staff have included in this budget's proposal some safeguards, guidelines, and reporting requirements associated with the proposed authority to carry out these agreements related to the state's general obligation debt. The Building Commission would be required to contract with an independent financial consulting firm to determine if the terms and conditions of the agreement reflect a fair market value as of the proposed date of the agreement. Also, any interest exchange agreement would have to identify by maturity, bond issue, or bond purpose, the debt or obligation to which the agreement is related.

22. The bill would require that the resolution authorizing the Building Commission to enter into any agreement relating to state general obligation debt must require that the terms and conditions of the agreement reflect a fair market value as of the date of execution of the agreement. The Governor's recommendation would also require that the terms and conditions of an interest exchange agreement reflect the fair market value of the agreement, as determined of the independent financial consulting firm. The bill would also require that the resolution establish guidelines for any interest rate exchange agreement relating to general obligation debt, including the following: (a) the conditions under which the Commission may enter into the agreements; (b) the form and content of the agreements; (c) the aspects of risk exposure associated with the agreements; (d) the standards and procedures for counterparty selection; (e) the standards for the procurement of, and the setting aside of reserves, if any, in connection with, the agreements; (f) the provisions, if

any, for collateralization or other requirements for securing any counterparty's obligations under the agreements; and (g) a system for financial monitoring and periodic assessment of the agreements.

23. In order to address the legislative oversight and reporting requirements concerns identified with the past proposals, the bill would require DOA to submit a report, semiannually, during any year in which the state is a party to an agreement relating to state general obligation debt listing all such agreements. The report would be submitted to the Building Commission and to the Co-chairpersons of the Joint Committee on Finance. The report would have to include all of the following: (a) a description of each agreement, including a summary of its terms and conditions, rates, maturity, and the estimated market value of each agreement; (b) an accounting of amounts that were required to be paid and received on each agreement; (c) any credit enhancement, liquidity facility, or reserves, including an accounting of the costs and expenses incurred by the state; (d) a description of the counterparty to each agreement; and (e) a description of the counterparty risk, the termination risk, and other risks associated with each agreement.

24. These reporting requirements would only apply to general obligation bonds. Therefore, these provisions would not apply to the state's appropriation obligation, revenue obligation, and operating notes programs. In order to cover all of the state's borrowing programs, the Committee could make the interest rate exchange agreements related to these programs subject to the same guidelines and reporting requirements proposed for agreements related to the state's general obligation bond programs.

ALTERNATIVES TO BILL

1. Approve the Governor's recommended modifications relating to ancillary arrangements and agreements associated with the state's general obligation, appropriation obligation, revenue obligation, and operating note borrowing programs.

ALT 1	**Change to Bill** Funding	**Change to Base** Funding
GPR-Lapse	$0	$4,500,000

2. In addition to Alternative 1, do the following:

a. Specify that the proposed limitations on off-market interest rate exchange agreements related to the state's general obligation and appropriation obligation debt programs would also apply to off-market interest rate exchange agreements related to the state's revenue obligation and operating note borrowing programs.

b. Specify that the proposed guidelines and reporting requirements for agreements related to the state general obligation programs would also apply to agreements related to the state's appropriation obligation, revenue obligation, and operating note borrowing programs.

3. Modify that Governor's proposal, by prohibiting the Building Commission or DOA from entering into off-market interest rate exchange (swap) agreements relative to its general obligation and appropriation obligation debt programs.

4. Delete provision.

ALT 4	**Change to Bill** Funding	**Change to Base** Funding
GPR-Lapse	**-** $4,500,000	$0

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Attachment

ATTACHMENT

Summary of Governor's Recommendations

Make the following modifications to relating to the payment and receipt of funds on agreements and ancillary arrangements associated with the state debt obligation programs and operating notes:

Modifications to State General Obligation Debt. Specify that the Building Commission could enter into agreements or ancillary arrangements relating to public debt at the time of, or in anticipation of contracting the public debt and at any time the public debt is outstanding. Require the Building Commission to determine the following, if applicable, with respect to revenues or payments on any agreement or ancillary arrangement entered into relating to state debt: (a) whether revenues will be deposited into the bond security and redemption fund (BSRF) or the capital improvement fund (CIF); and (b) whether any payment to be made will be made from the BSRF or the CIF and the timing of any transfer of funds. Under current law, the BSRF is used to pay debt service on state general obligation bonds and monies from agency debt service appropriations are transferred to the BSRF, and then paid to bondholders when due. The CIF is used for the deposit of bond proceeds at the time bonds are issued. These bond proceeds are expended from the CIF as project expenditures need to be made.

Provide that monies received from the issuance of public debt or payments from any agreement or ancillary arrangement relating to public debt would be deposited in the CIF, except as follows: (a) such monies representing accrued interest or that are for funding or refunding bonds would be credited to the BSRF or the building trust fund; and (b) any such monies that represent a premium or that are from an agreement or ancillary arrangement relating to public debt could be credited to the BSRF or the CIF, as determined by the Building Commission. Under current law, monies received from the issuance of public debt are deposited in the CIF, except that any monies representing a premium or accrued interest or that are for funding or refunding bonds are credited to the BSRF or the building trust fund.

Authorize expenditures from the CIF for any payment due under an agreement or ancillary arrangement with respect to public debt and modify current law governing the transfer of the proceeds of public debt to the CIF to pay loans or notes or pay expenses incurred in contracting public debt, to also apply to these payments.

Modify current law governing expenditures from the BSRF to add payments due under an agreement or ancillary arrangement as an allowable purpose. Under current law, the BSRF is used to pay principal, interest and premium, if any, on public debt. Related provisions concerning debt service appropriations and the BSRF would be modified to reflect this additional spending purpose. The bill would modify each state general obligation debt service appropriation to add payments due under an agreement or ancillary arrangement as an allowable expenditure from the appropriation.

Delete the current law limitation that an interest exchange agreement is not considered public debt of the state. Require the following with respect to any interest exchange agreement or agreements relating to state public debt:

a. the Building Commission would be required to contract with an independent financial consulting firm to determine if the terms and conditions of the agreement reflect a fair market value as of the proposed date of the execution of the agreement; and

b. the interest exchange agreement would have to identify by maturity, bond issue, or bond purpose the debt or obligation to which the agreement is related. The bill would specify that any determination of the Building Commission included in an interest exchange agreement that such agreement relates to a debt or obligation would be conclusive.

Specify that the resolution authorizing the Building Commission to enter into any interest exchange agreement relating to state general obligation debt must require that the terms and conditions of the agreement reflect a fair market value as of the date of execution of the agreement, as reflected by the determination of the independent financial consulting firm and would establish guidelines for any such agreement, including the following: (a) the conditions under which the Commission may enter into the agreements; (b) the form and content of the agreements; (c) the aspects of risk exposure associated with the agreements; (d) the standards and procedures for counterparty selection; (e) the standards for the procurement of, and the setting aside of reserves, if any, in connection with, the agreements; (f) the provisions, if any, for collateralization or other requirements for securing any counterparty's obligations under the agreements; and (g) a system for financial monitoring and periodic assessment of the agreements.

Authorize the Building Commission to delegate to other persons the authority and responsibility to take actions necessary and appropriate to implement interest rate exchange agreements. It is the intent that this authority would only be delegated to DOA Capital Finance staff or a trustee involved in a transaction, which would likely be indicated in the authorizing resolution approved by the Commission.

The bill would require DOA to submit a report, semiannually, during any year in which the state is a party to an agreement relating to state general obligation debt, to the Building Commission and to the Co-chairpersons of the Joint Committee on Finance listing all such agreements. The report would have to include all of the following: (a) a description of each agreement, including a summary of its terms and conditions, rates, maturity, and the estimated market value of each agreement; (b) an accounting of amounts that were required to be paid and received on each agreement; (c) any credit enhancement, liquidity facility, or reserves, including an accounting of the costs and expenses incurred by the state; (d) a description of the counterparty to each agreement; and (e) a description of the counterparty risk, the termination risk, and other risks associated with each agreement.

Specify that payments under these arrangements would have the same priority of payment as debt service on general obligation bonds, under current law governing payment delays if a state fund has cashflow problems.

Modifications to Appropriation Obligation Debt. Specify that the determination by DOA in an interest exchange agreement that the agreement relates to an appropriation obligation debt would be conclusive.

Limitations on Interest Rate Agreements on General and Appropriation Obligation Debt. Provide that the terms and conditions of an interest exchange agreement relating to general obligation and appropriation obligation debt, could not be structured so that, as of the trade date of the agreement, both of the following would reasonably be expected to occur:

a. the aggregate expected debt service and net exchange payments relating to the agreement during the fiscal year in which the trade date occurs will be less than the aggregate expected debt service and net exchange payments relating to the agreement that would be payable during that fiscal year if the agreement is not executed; and

b. the aggregate expected debt service and net exchange payments relating to the agreement in subsequent fiscal years will be greater than the aggregate expected debt service and net exchange payments relating to the agreement that would be payable in those fiscal years if the agreement is not executed.

Provide that this limitation on structuring an agreement would not apply if either of the following occurs:

a. the Commission (DOA for appropriation obligation debt) receives a determination by the independent financial consulting firm that the terms and conditions of the agreement reflect payments by the state that represent on-market rates as of the trade date for the particular type of agreement; or

b. the Commission (DOA for appropriation obligation debt) provides written notice to the Joint Committee on Finance of its intention to enter into an agreement that is reasonably expected to be subject to the limitation on structuring interest rate agreements, and the Joint Committee on Finance either approves or disapproves, in writing, the Commission's entering into the agreement within 14 days of receiving the written notice from the Commission.

Specify that the interest rate exchange agreement limitations would not limit the liability of the state under an agreement if actual contracted net exchange payments in any fiscal year exceed original expectations.

Specify that for arrangements and agreements related to the state's general obligation program, aggregate expected debt service and net exchange payments would mean the sum of the following: (a) the aggregate net payments expected to be made and received under a specified interest rate exchange agreement; (b) the aggregate debt service expected to be made on bonds related to that agreement; and (c) the aggregate net payments expected to be made and received under any other interest exchange agreement relating to bonds that are in force at the time of executing the agreement

Modifications to Operating Note Obligations. Under current law, there are references that specify that the Building Commission's authority to enter into agreements and ancillary arrangements for public debt applies to operating notes. Create similar authority under the statutes governing operating notes, except specify that the Commission would have that authority at the time of, or in anticipation of, and after issuing operating notes. Specify that the determination by the Building Commission that an interest rate exchange agreement relates to an operating note would be conclusive.

In addition, specify that any payment made or received under such agreements or arrangements would be made from, or deposited to, the general fund or the operating note redemption fund, as determined by the Commission.

Specify that all moneys resulting from payments to be received under an agreement or ancillary arrangement regarding operating notes would be credited to the general fund. Authorize the operating note redemption fund to make payments due on an agreement or ancillary arrangement entered into with respect to operating notes. Specify that the payments due under these agreements or arrangements with respect to operating notes would be an allowable purpose for which funds could be transferred from the GPR sum sufficient appropriation for debt service on operating notes to the operating note redemption fund.

Modifications to Revenue Obligations. Specify that the determination by the Building Commission in an interest exchange agreement that the agreement relates to a revenue obligation would be conclusive. The proposal would also allow payments under an agreement or ancillary arrangement related to revenue obligation debt issued for the transportation revenue bond program, the clean water revenue bond program, and the PECFA revenue bond program to be received by, and made from, the trusts of these various programs. Modify the debt service appropriations for each of these programs to add payments due under an agreement or ancillary arrangement as an allowable expenditure from the appropriation.