Michigan Department of Treasury
Bureau of Bond Finance
School Bond Qualification and Loan Program

Bond Structures With
Variable Rate and Derivative Transactions
January 5, 2009

Bond issues using variable rate debt and derivative transactions are more complex in nature and may interact differently with the School Loan Revolving Fund (SLRF) than bond issues using traditional fixed rate financing structures. By their nature, variable rate structures and derivative transactions such as an interest rate exchange or swap, hedge, or other similar agreement, (hereafter referred to as "swaps") include certain risks that are not present in fixed rate bond structures and require additional on-going administrative evaluation.

The following information pertains to bond structures with variable rate or derivative transactions and qualification to participate in the School Bond Qualification and Loan Program:

Section 1 –Approval of Bonds
Section 2 –Borrowing from the SLRF
Section 3 –Additional Information Related to Swaps

1. <u>Prior to Approval of Bonds Using Variable Rates or Swaps</u>:

a. Participation in the School Loan Revolving Fund does not eliminate the need for a liquidity facility nor is its purpose to mitigate the effects of market, interest rate, counterparty or other risks that might impact the swap agreement.

b. The school district's total outstanding long-term debt should not include more than 25 percent of variable rate debt at the time of issuance unless it has been hedged through a variable to fixed interest rate swap agreement.

c. Bond payment dates are on May 1 and/or November 1.

d. The school district prepares a written acknowledgement of the potential risks, up front and on-going costs, and on-going administrative requirements associated with a swap agreement and submits a copy of this written acknowledgment with the application for final qualification of bonds filed with the Department of Treasury.

e. The school district complies with all requirements defined within MCL 141.2317 (Section 317) of the Revised Municipal Finance Act (Act 34).

f. The school district adopts a debt management plan as stipulated in Sec 317(9)(a) of Act 34 and files it with the Department of Treasury. The plan should also identify the school district administrators that are responsible for directing the monthly activities of the various agreements.

g. Before committing to the swap agreement, the school district adopts a swap management plan as stipulated in Sec 317(9)(b) of Act 34 and submits it to the Department of Treasury. The plan should also address the strategies or events that would result in termination of the swap agreement.

h. Bond indenture documents include the following provisions, as applicable:
    i. Flexibility to convert variable rate bonds to fixed rate bonds.
    ii. Qualified bonds are not subject to acceleration prior to maturity.
    iii. Notice is given to the Department of Treasury 30 days prior to borrowing from the School Loan Revolving Fund as required by MCL 388.1933.
    iv. The tax-exempt status, if any, of the state debt issued to finance loans to school districts is maintained .
    v. Notice is given to the Department of Treasury of changes in the indenture agreement, swap agreement or counterparties.
    vi. Notice to and approval by the Department of Treasury of change to maximum interest rate, or change to the indenture or swap documents that affect the School Bond Qualification and Loan Program.
    vii. Advance notice to the extent possible, to the Department of Treasury by the school district if a circumstance occurs that may lead to termination of a swap agreement.
    viii. Termination payments received by the school district may only be used for reasonable direct costs of establishing a subsequent swap agreement. Any excess funds not used for this purpose will be deposited into the debt retirement fund established for the bonds unless specific prior written approval for another use has been received from the Department of Treasury.
    ix. The notional amount of an interest rate swap agreement will never exceed the principal amount of the outstanding bonds.
    x. The notional amount of the swap agreement does not exceed the principal amount of the outstanding bonds. As bond payments are made, or in the event of a refunding, redemption or defeasance, the notional amount of a swap agreement will be correspondingly reduced to the principal amount of the outstanding bonds.

i. Indenture and swap documents conform to the stipulations outlined in the district's application for final qualification of bonds as certified by the school district's board of education.

j. Events of default, termination events, swap transaction provisions (including the selected index), and other provisions outlined in the indenture and swap documents that impact the potential liability of the School Loan Revolving Fund, are acceptable to the Department of Treasury.

2. **<u>Prior to Borrowing from the School Loan Revolving Fund</u>:**

a. During the first year, the full debt levy on all taxing units is certified before borrowing from the School Loan Revolving Fund. To avoid borrowing prior to the date when sufficient taxes will be certified, it may be necessary to capitalize interest or establish an initial fixed interest rate period.

b. Loans to a school district from the School Loan Revolving Fund may only be applied to principal and interest payments of qualified bonds as defined in Public Act 92 of 2005 (as amended) and may not be used to pay a termination payment related to a swap.

c. The debt payment transfer to trustee or paying agent is made five days prior to the due date.

d. School bond loan proceeds are expended within five banking days of receipt of the funds.

e. Emergency loan procedures to prevent default of payment of qualified bonds for any reason remain in full force.

f. If the district has multiple debt funds, the debt millage levy is properly allocated between funds.

g. Applications for loans are submitted not less than 30 days prior to the date when the proceeds of the loan will be needed to pay debt service.

h. A minimum debt retirement fund balance within IRS regulations is maintained to limit borrowing from the SLRF fund to the regularly scheduled May and November borrowings.

i. School district submits supplemental schedules detailing the estimated debt service payments projected for the upcoming year during annual loan activity application processing to the Department of Treasury.

If changes occur during the terms of the bonds the following documents should be provided to Treasury:

j. Written notification if the district elects to convert the variable rate bonds to fixed rate bonds, or there has been a change to the liquidity facility.

k. Written notification if there is termination of a swap agreement or any change in the counterparties.

l. Written notification if changes are made to the maximum interest rate, to the indenture documents or the swap documents that affects the School Bond Qualification and Loan Program. Approval of these changes may be assumed if the Department of Treasury does not respond in writing within 30 days after the school district notifies the Department.

3. <u>Additional Information Related to Swaps</u>:

Documents to be submitted with final qualification application:

a. Written acknowledgement from the school district that the school board has been informed of the potential market risks, up front and on-going costs, and administrative requirements associated with issuing variable to fixed rate swap.

b. Letter from bond counsel confirming that bond indenture documents and swap agreements include provisions specified herein and that the conditions for issuing variable to fixed rate swap have been met.

c. An analysis that demonstrates the economic benefit of the swap arrangement (after considering on-going costs) when compared to a fixed interest rate structure on a present value basis.

d. School district's debt management plan.

e. School district's swap management plan.

f. Trust indenture agreement and any supplemental agreements or confirmations.

g. Swap agreement and any supplemental schedules, agreements or confirmations. Upon agreement with the Department of Treasury, parties of agreements that have been approved in previous final qualification applications may submit an analysis of differences between current indenture and swap agreement documents and the previous versions in lieu of complete copies of trust indenture or swap agreements.

At the conclusion of each fiscal year or before additional debt is issued:

h. The school district's chief financial officer should complete an update of the district's debt management plan and a status report of all outstanding swap agreements including an estimate of the termination value.

i. Upon request of the Department of Treasury, the school district should provide a copy of its updated debt management plan and/or its status report including the estimated termination values.

j. The swap agreement and its current status should be appropriately described in the school district's annual audit report.