The Variable-Rate Demand Note: A Primer

This Important Investment Vehicle Enables Cash Investors to Capture the Benefits of Tax-Exempt Bonds without Assuming Excessive Risk

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The weak economy and resulting shortfalls in tax revenue have left many states and municipalities facing substantial budget deficits. These fiscal challenges and the attendant drops in issuer credit ratings have raised concerns among investors about the suitability of tax-exempt bonds for cash portfolios.

While investors are well aware of the risks presented by today's difficult fiscal environment, they likely are less familiar with a widely used tool to address those risks, the variable-rate demand note (VRDN). VRDNs effectively convert long-term municipal bonds into short-term, highly liquid instruments that are appropriate for cash portfolios. They do so through two important features:

- Periodic interest rate resets (usually daily or weekly), which ensure that the yields on VRDNs reflect the current interest rate environment.
- Liquidity facilities – typically provided by highly rated financial institutions – that allow investors to "put"[1] the VRDN at par value prior to the maturity date. By making the instrument more liquid than the underlying municipal security, the VRDN changes the risk profile of the issue, enabling the portfolio managers to deliver the tax advantages and diversification benefits presented by municipal bonds to cash investors.

THE MECHANICS OF VRDNs

As noted above, the defining features of a VRDN are its variable rate (through the rate reset) and the put feature. The put feature is particularly significant because it enables the manager of a money market fund or other cash portfolio to quickly exit an investment.

Say, for example, the manager decides to sell a given VRDN to free up funds to purchase a potentially better-performing credit, he or she can put it to the VRDN's remarketing agent at par value. Typically a bank or brokerage, the remarketing agent then seeks to sell the VRDN to another investor. If the remarketing agent cannot find a buyer, it puts the security to the bank or other financial institution providing the aforementioned liquidity facility. The provider of the liquidity facility is effectively the buyer of last resort for the VRDN, enabling the manager to exit the investment even if market conditions are not conducive to a sale.

It is important to note that a VRDN's put feature can be negated if certain events occur. These events, known as "tender option termination events," include:

- The failure of the issuer and credit facility to make interest and principal payments on the bonds or other bonds with the same security
- The bankruptcy of the issuer
- The lowering of the VRDN's credit rating by all of the ratings agencies
- The revocation of a credit's tax-exempt status by the Internal Revenue Service

These events do not occur often, but when they do, they void the put feature. This is why many VRDNs feature a second safeguard: the direct-pay letter of credit (LOC).

Issued by a highly rated financial institution, a direct-pay LOC obligates the provider to pay principal and interest to bondholders. The LOC provider is reimbursed by the obligor of the bond within a certain time frame delineated in the bond documents. The provider of the LOC must meet its obligations even if the issuer of the VRDN fails to reimburse

[1]A put is an option contract that allows the owner to sell a specified amount of an underlying security at a specified price during a specified period of time, i.e., before the contract's expiration date. With VRDNs, the put feature obligates the remarketing agent to redeem the security at par value prior to the maturity date.

the LOC provider. Not all VRDNs include a LOC, but almost all of the VRDNs in BofA Global Capital Management's cash portfolios have the added protection of direct-pay letters of credit.

Needless to say, the financial institution's pledge to make investors whole in the event of a default or other adverse event is only as good as the institution's willingness and ability to meet its obligations. For that reason, BofA Global Capital Management's credit analysts conduct extensive due diligence not only on the bond's issuer, but also on the financial institution that provides the direct-pay letter of credit. When evaluating the letter-of-credit provider, it is vital to ascertain that the bank or other institution has guaranteed the VRDN for the entire holding period and that it is not too heavily leveraged in the market.

THE VALUE OF VRDNS

For cash investors, VRDNs make it possible to capture the diversification benefits and the tax advantages offered by municipal bonds, while addressing the risks that otherwise would make tax-exempt securities unsuitable for cash portfolios. Indeed, the liquidity facility and the direct-pay letter of credit features enable cash investors to tap the tax-exempt bond market by addressing the central threats to the viability of short-term debt portfolios: the absence of liquidity and the loss of principal.

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Prior to joining Bank of America, Ms. Dushock held a position at Digital Assurance Certification. She began her career at Lehman Brothers doing housing bond analysis, later expanding into health care and higher education. She pioneered early work on prepayments and worked closely with housing issuers to provide useful and timely disclosure to municipal market bond buyers.

Ms. Dushock received her B.A. from Queens College, CUNY. She was named an Institutional Investor and Global Guaranty (now Smith's Research) first- or second-team member for municipal housing on a number of occasions. She is a frequent speaker at industry conferences. She served as president of the Municipal Bond Women's Club of New York, was the chair of the Southern Municipal Analysts Society and a member of the board of governors of the National Federation of Municipal Analysts.