MANAGEMENT INNOVATION – FINANCIAL
PURCHASING CHFA'S OWN VRDOS AS SHORT-TERM INVESTMENTS
Entry Description

Background

In September 2008, in response to the Lehman Brothers bankruptcy and the Reserve Primary Fund (the oldest money fund in the nation) becoming the first money-market fund in 14 years to expose investors to losses because the net asset value dropped below a dollar per share ("broke the buck") due to exposure to Lehman, the Connecticut Housing Finance Authority (CHFA), like many other state housing agencies and municipal issuers had a large amount of its variable rate demand obligations (VRDOs) put to its various liquidity banks (VRDOs became Bank Bonds). Further compounding the problem was the rating agencies' downgrade of one of CHFA's largest liquidity providers. The net result was that CHFA had over $500 million of bonds put to liquidity banks and its weekly rate resets went from under 2% to almost 10%. By year-end CHFA was able to obtain $180 million of liquidity from a new provider, and with some of the other bonds back in the market, it was left with approximately $280 million of Bank Bonds at unattractive rates.

Program Description

The problem with Bank Bonds is that the rate on the bonds is much higher than similar bonds in the market, resulting in additional interest expense. Also, Bank Bonds have to be retired much more quickly than the normal sinking fund requires. To mitigate these two problems, CHFA developed a program to purchase its own VRDOs as short-term investments. This program used already existing short-term investment funds that were invested in the State's money market fund to purchase the approximately $280 million of bonds. At the time of the VRDO purchase these short-term investment funds were earning less than 0.75% while the Bank Bonds were costing the Authority 3.25% to 4.25%. CHFA's VRDOs were bought directly from the liquidity banks or from the remarketing agents using these funds. The result was a substantial savings on interest costs, $100,000 to $200,000 per week in savings. It also gave CHFA time to find a permanent solution since the accelerated term-out stopped.

The program gave CHFA time to secure two new liquidity facilities, $100 million from one provider and $80 million from a second provider. This additional liquidity was used to refund $180 million of the purchased VRDOs and put them back in the market. The current reset on these bonds is 0.20%.

Innovative

The program was a simple, cost effective solution to a complex problem. No additional staff was needed, costs were minimal (mostly attorney costs to amend the general bond resolution and to draft liquidity bank consents) and the savings were substantial. It made use of a recent Treasury Department regulation allowing for municipal bond issuers to purchase and hold their own municipal tax-exempt debt for longer than ninety days without that debt being retired. This provision is due to expire on December 31, 2009. While the ability to purchase and hold tax-exempt debt expires on December 31, there is no such restriction on how long taxable bonds can be held, and there is always the chance that the tax-exempt provision will be extended.

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Replicable
Any municipal issuer that has variable rate funds available and VRDOs outstanding can set up a similar program as long as its governing laws allow. The program works well for taxable VRDOs also, which have no time constraint. When an issuer's rate of return on its short-term investments is less than the rate it is paying on its VRDOs, then it is to the issuer's advantage to purchase the outstanding VRDOs with the invested funds and pocket the savings differential. The issuer can buy and sell these VRDOs to take advantage of discrepancies in the market.

Responds to a Management Challenge or Opportunity
The financial management challenge was to stop the high cost of the Bank Bonds and to stop the accelerated retirement of affected bonds. The opportunity arose with the recent Treasury Department regulation allowing for municipal bond issuers to hold their own tax-exempt municipal debt without that debt being retired.

Provides Benefits that Outweigh Cost
Since there was no additional staff required, the only costs became (i) amount of legal expenses to modify the general bond resolution, and develop consent agreement for the liquidity banks, (ii) additional cost for CHFA's financial advisor and (iii) the opportunity costs associated with the investments that were sold to obtain the funds to purchase the bonds. The lawyer costs and financial advisor costs were relatively small and the funds used to purchase the bonds were earning from 0.5% to 1.0%. The benefit was tremendous, a net savings of between $100,000 and $200,000 a week, depending on the amount of bonds owned and the then current interest rates.

Demonstrates Effective Use of Resources
CHFA maintains an average of approximately $500 million of short-term investments mainly in the State's money market fund. These funds are used for the liquidity needs of CHFA. At the time of the purchase of CHFA's own VRDOs, these invested funds were earning a rate of between 0.5% and 1%. It became much more effective to use these funds to purchase its own VRDOs. The savings from not having Bank Bonds was much greater than the loss of money market interest.

While the program was originally established to purchase Bank Bonds it remains in place and is useful to help mitigate the negative arbitrage problem. When the rates earned on short-term investments are less than the rates paid on the taxable VRDOs, the short-term investments are sold and these funds are used to temporarily purchase the VRDOs, thus eliminating the negative arbitrage. When the market improves the bonds are sold back into the market.

Achieves Strategic Objectives
CHFA's purpose is to meet the housing needs of low- and moderate-income families and persons in the State. By purchasing its own VRDOs, CHFA effectively reduced its cost of borrowing and thus can reduce the cost of mortgages it provides.