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SLABS MARKET DEVELOPMENTS: VRDOS

Short-term investors looking for a yield pickup have often turned to auction-rate securities (ARS) backed by relatively risk-free government-guaranteed student loans. The 28-day (35-day for tax-exempt issues) ARS provide an interest rate higher than that of money market funds, a short risk window and, prior to September 2007, a historically liquid market. The ARS notes, however, have 20- to 30-year legal maturities and no put feature that allows investors to tender their bonds at their own discretion. Despite having a short auction period, investors in ARS could be forced to hold on to the notes in the event of a failed auction. For this reason, ARS do not qualify under the Securities and Exchange Commission's Rule 2a-7, which sets qualifications for money market fund investment eligibility.

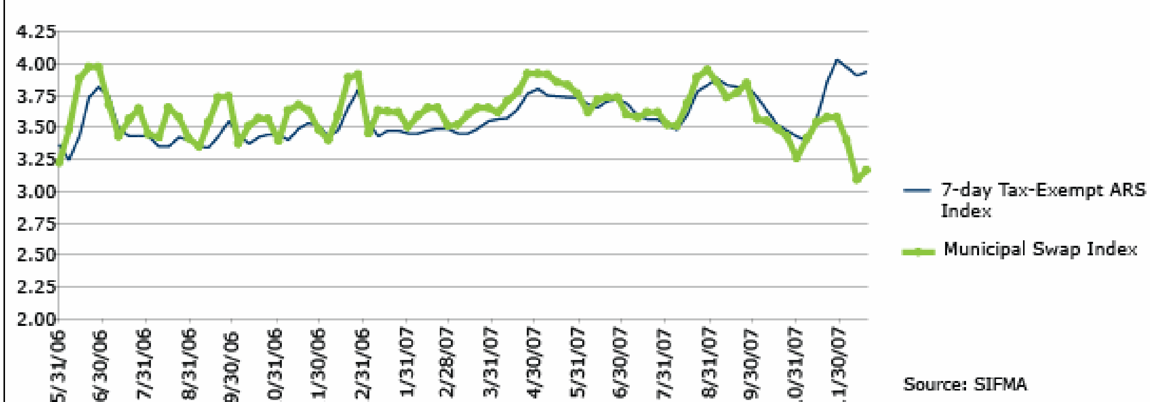
Rates on ARS have historically tracked one-month LIBOR, minus a few basis points. However, in recent months, rates on ARS have increased sharply as demand for ARS has declined with eroding investor demand across all structured finance products. This increase in issuers' cost of funds has caused some ARS issuers to seek ways to refinance outstanding ARS as well as provide an alternative means of financing new collateral. One avenue for achieving this objective is to issue securities in the variable-rate demand obligations (VRDOs) market, which currently offers more liquidity.

VRDOs are short-term, either taxable or tax-exempt securities with an interest rate reset, most often occurring either daily or weekly. Common SLABS VRDO issuances have either seven-day or ten-day remarketing periods. Despite having long (30 to 40 year) stated maturities, VRDOs include a put feature that makes the notes Rule 2a-7 eligible, thus widening the investor base for the notes. VRDOs are usually supported by a facility providing either 1) both credit and liquidity support, often in the form of a Letter of Credit (LOC), or 2) liquidity support only, in the form of a Standby Bond Purchase Agreement (SBPA). The liquidity support provided by these facilities allows VRDO investors to exercise a put at a price of par, plus accrued interest at any interest payment date.

Rates on VRDOs are set by remarketing agents. Taxable VRDOs tend to trade comparably to one-month LIBOR and tax-exempt VRDOs tend to trade comparably to the Municipal Swap Index (MSI) maintained by The Securities Industry and Financial Markets Association (SIFMA; formerly the Bond Market Association/PSA Municipal Swap Index)[1].

For issuers, VRDOs carry the additional costs associated with securing the LOC or SBPA. However, those costs can be offset by a lower interest rate coupon on the notes and lower remarketing fees versus broker-dealer and auction agent fees that come with ARS.

Chart 1: 7-day Tax-Exempt ARS Index vs. Municipal Swap Index



Source: SIFMA

For questions or comments, please contact David Hartung at dhartung@dbrs.com or David Laterza at dlaterza@dbrs.com.

[1] The MSI is a seven-day high grade market index comprised of tax-exempt VRDOs produced by Municipal Market Data (MMD) and, at any time, represents approximately 650 VRDO issuances out of MMD's database of over 15,000 active VRDOs. Source: SIFMA website.