GFOA BEST PRACTICE APPLICABLE IN CANADA

Using Variable Rate Debt Instruments (2003) (2011) (DEBT)*

Background. Issuing variable rate debt is a sophisticated strategy. In optimal conditions a government might experience lower borrowing costs or reduce the impact of volatile investment earnings by issuing variable rate securities; however, their use exposes governments to many additional forms of risk. Users of variable rate debt need to be informed about these risks and their implications and possess or retain substantial expertise to mitigate them.

Short-term interest rates are generally lower than long-term interest rates. Governments with debt that resets to prevailing interest rates can save money in their long-term financing if rates stay constant or fall over the life of the debt. If rates rise, governments are better off issuing fixed-rate debt from the outset. This interest rate risk is only one form of risk associated with variable rate debt. Additional risk is introduced by liquidity and remarketing provisions. Variable rate debt programs typically involve regular remarketing or rollover events, and these provisions determine what happens when there are problems in that process. Those problems can impose sudden principle repayments or large increases in interest rates.

In addition to these forms of risk, governments need staff to actively monitor and manage variable rate debt throughout the time that it is outstanding. Governments without the capacity to manage such a program or who cannot secure the expertise to do so should consider issuing fixed rate debt.

Variable rate debt can be used as a tool for interim financing. Since the expectations of variable-rate investors are, by their nature, short-term, variable rate debt can be redeemed on short notice without any penalty. This feature makes variable rate debt a preferred toll for financing projects for which a prepayment or restructuring is a high probability. Certain variable rate products, most notably commercial paper, can be issued incrementally as funds are needed to finance current construction and reduce the long-term cost of construction financing, and then refunded with a long-term financing when the project is completed. Although variable rate debt is a valuable instrument, issuers should consult with their independent financial advisors and rating agencies to determine the appropriate level of variable rate exposure for the individual circumstance.

Recommendation. The Government Finance Officers Association (GFOA) recommends governments who plan to use variable rate debt to exercise caution and carefully evaluate their objectives and consider how this debt and the various risks associated with it will be managed over the long-term. Issuance of variable rate debt should be guided by the government’s overall financial and debt management objectives and its financial condition. In particular, an issuer should:

1. Review legislation governing the issuance of debt to ensure that issuance of variable rate debt (including particular instruments) is permitted and to understand any conditions, such as amounts, interest rate ceilings, or requirements governing debt-related funds.

2. Ensure that the government's debt policy specifically addresses the use of variable rate debt, including goals to be achieved, permitted instruments, amounts that may be issued, and steps to minimize risk.

3. Evaluate the impact on debt service requirements assuming different interest rate scenarios and develop appropriate contingency plans for a rising interest rate environment, including setting aside reserves or purchasing hedging instruments. An issuer also should consider the impact of changing interest rates on rate covenants and its financial position. Governments using variable rate debt should have adequate financial capacity to accommodate rapid and potential large chances in borrowing.

4. Evaluate the total cost of issuing variable rate debt, including fees to tender agents, remarketing agents, and liquidity providers under expected and adverse scenarios (e.g., if tendered bonds cannot be immediately remarketed). If the issuer is considering an interest rate cap, the cost of purchasing the instrument also should be assessed in relation to interest rate risk exposure. The issuer should include the cost of financial advisors or other expertise needed to monitor the variable rate instrument

5. Evaluate the need for an externally provided liquidity facility. If needed, an issuer should undertake an evaluation of possible providers, including their credit rating, the impact of a possible change in this rating, and renewal provisions.

6. Ensure the diversification of remarketing agents, liquidity facility providers and counterparties in their selection. This would assist the issuer in diversifying its exposure in market uncertainties and create competition among the various marketing agents.

7. Develop a full understanding of the unique risks that arise when variable rate payments are realized through an interest rate swap, including counterparty risk, basis risk, rollover risk, and termination risk. Other GFOA recommended practices pertaining to the use of these products should be reviewed.

To evaluate the appropriate amount of variable rate debt to be issued for risk mitigation purposes, the following criterial should be evaluated:

1. Balance sheet risk mitigation. The following factors should be analyzed on the basis of the fund that will be repaying the debt:
    a) The historic average of cash balances over the course of several prior fiscal years;
    b) Projected cash balances based on known demands on a given fund and on the issuers fund balance and policies.
    c) Any basis risk, such as the difference in the performance or duration of the issuer's investment vehicle compared to the variable rate debt instrument to be used by the government.
2. Interest Rate Risk. In determining the amount of interest rate risk, the issuer should consider the specific fund exposed to the risk and the budgetary flexibility that fund has in accommodating rapid increases in interest rates.
3. Remarketing Risk. Issuers should have specific backup contingencies in the event that they cannot remarket their bonds. These should include sources of funds to cover redemptions and provisions for substitution remarketing.
4. Liquidity/Renewal Risk. Issuers should have a plan that specifies their actions and backup provisions should one or more guarantors to the transaction fail to perform. This also applies to a government's ability to renew its liquidity agreements during a difficult market.
5. Rollover Risk. Issuers should have the flexibility to act quickly if bonds rollover and cannot be sold, in which case remarketing agents effectively "put" their bonds. Documents should clearly indicate how the issuer should handle these bonds.

References.

- GFOA Recommended Practices:
    - *Use of Derivatives by State and Local Governments,*" 1994.
    - *Using Variable Rate Debt Instruments* (1997), Approved by the GFOA's Executive Board, 1997.
- "Variable Rate Debt and Minneapolis' Debt Management Policy," Government Finance Review, GFOA, April 1988.
- "Debt Markets and Instruments," Local Government Finance: Concepts and Practices, GFOA, 1991.
- "An Issuer's Perspective on Interest Rate Swaps," Government Finance Review, GFOA, October 1992.
- "Credit Impact of Short-Term and Variable-Rate Debt," Standard & Poor's CreditWeek Municipal, September 30, 1996.
- Dall W. Forsythe, "Managing Interest Rate Exposure: Some Simple Tools for Financial Managers," Government Finance Review, GFOA, August 1996.

Approved by the GFOA Committee on Canadian Issues, 21 May, 2011.