

## LFC HEARING BRIEF

**AGENCY:** New Mexico Finance Authority, New Mexico Student Loans, Board of Finance, State Treasurer's Office

**DATE:** April 23, 2008

**PURPOSE OF HEARING:** Update on debt issues facing New Mexico public finance entities

**WITNESS:** John Bonow, Managing Director, The PFM Group; Treasurer James Lewis; David Paul, Fiscal Strategies (for Board of Finance); Elwood "Woody" Farber, President NM Student Loans

**PREPARED BY:** Norton Francis, Chief Economist; Arley Williams, Principal Analyst

**EXPECTED OUTCOME:** Assessment of the exposure to risk facing New Mexico agencies and entities

**Understanding of key issues facing decision-makers regarding**

- Variable rate versus fixed rate debt instruments
- Policy responses to failed markets
- Use and monitoring of interest rate swaps

### BACKGROUND INFORMATION

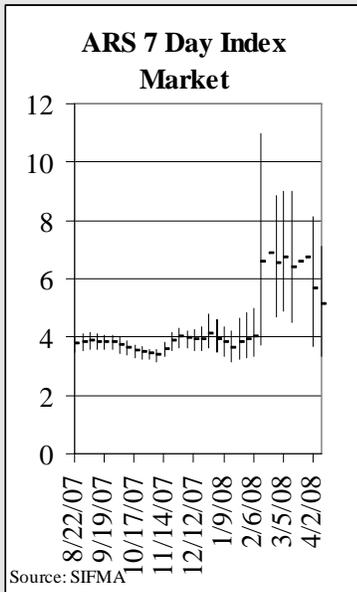
In November 2007, winning bids at auctions for debt instruments began to rise above the SIFMA index. (Note: the sidebars beginning on page two define key terms used in this brief and the presentations.) This was the month that the credit ratings of AAA rated bond insurance companies were called into question and some of big banks were reporting major losses from exposure to the subprime mortgage market. As November began, there had been \$31.6 billion in bank and brokerage write-downs as a result of bad mortgage debt, primarily subprime exposure. Merrill Lynch and Citigroup led with \$7.9 billion and \$6.5 billion, respectively. Virtually unknown to main street, a few insurance companies that specialize in insuring municipal debt also reported trouble. PIRA, LFC's energy service provider, had begun a fiscal stress monitor which reports that since the high in summer 2007, the weighted capitalization of the mortgage and public bond insurance industry had gone down 60 percent.

By December, these companies, MBIA and Ambac in particular, were exposed to hundreds of billions of losses related to their exposure to leveraged loans and other securities tied to the real estate market. Since they were insuring debt backed directly or indirectly by mortgages, including subprime and alt-A, the bond insurers faced significant losses if mortgage defaults accelerated. These losses translated into investors worrying about the ability of the bond insurers to pay if the public debt they insured defaulted. Variable rate bonds whose interest rates are set through an auction process (auction rate securities) carry long-term bond insurance since they do not contain a "put" feature that would let investors force repayment of principal on any interest rate reset date – thus, investors have no structural liquidity when holding auction rate securities. In February, the desire of investors to sell their auction rate securities exceeded the willingness of the investment banks who marketed the bonds to purchase the securities and auctions across America began failing. Two New Mexico agencies were affected: New Mexico Finance Authority and New Mexico Student Loans.

The housing market continues its decline and the interconnections, primarily due to sophisticated financial mechanisms, are showing up in many portions of the credit marketplace and all corners of the globe. The figure below describes the path that leads from housing to failure in the auction rate securities (ARS) market and uncertainty in the variable and fixed rate markets. The last two boxes in blue show that this has not only impacted bond issuers who issued ARS but also

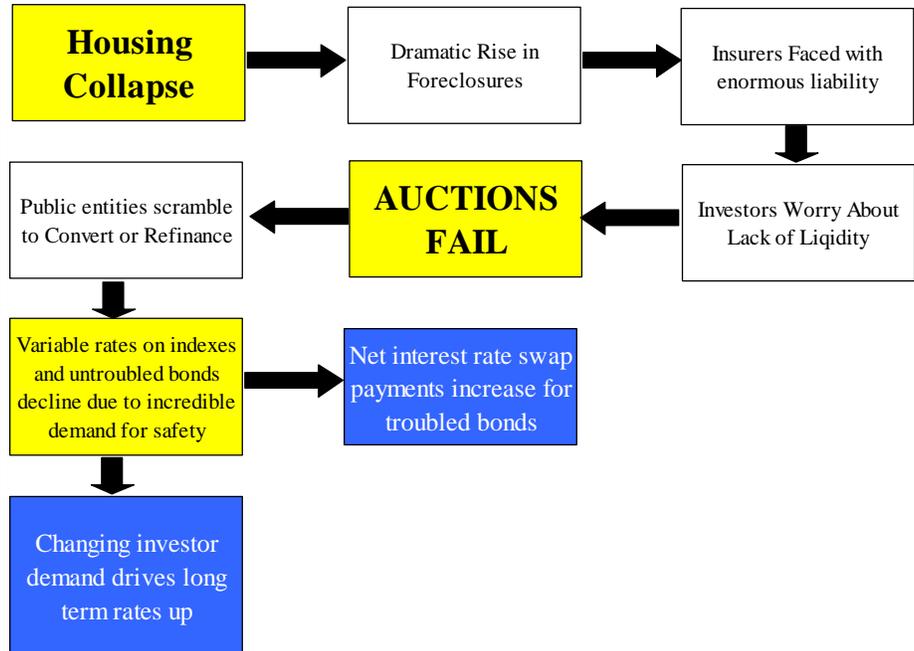
**Key Terms**

**Auction rate security** – an auction rate security (ARS) is similar to a variable rate bond but the rate is set periodically (e.g., weekly or monthly) by an auction rather than through a negotiation between a bank and prospective investors. The indenture for the underlying bond will state the frequency of auction, the failure rate, and the default rate. The failure rate is the rate that the last holder of the bond will receive if there are no bidders at an auction. The default rate is the rate in case of a payment default by the issuer. As the chart shows, the ARS 7 Day Index performed very well until late November when the volatility began increasing. The real collapse is apparent in February.



**Basis swap** – a basis swap is an interest rate swap that exchanges two indexes rather than a fixed for an index as in the interest rate swap. UNM uses a basis swap where UNM makes payments derived from

agencies engaged in interest rate swaps and agencies contemplating issuing long term fixed rate bonds. NMFA and UNM have interest rate swaps and the Board of Finance will be issuing a senior severance tax bond in June. The PFM Group, a consultant to LFC, has indicated that the medium term maturity of 10 years for BOF’s planned STB will fortunately be in the “sweet” spot along the fixed rate bond yield curve, which is experiencing great volatility and relatively high interest rates for longer-dated maturities (i.e., 20-30 years).



**SUMMARY OF MAJOR ISSUES**

- The credit crisis that has affected the nation is having an impact on transportation bonds and student loan bonds
- Both NMFA and NMEAF used auctions to determine the rate of interest on bonds; these auctions began failing in February 2008
- NMFA has converted most of its auction rate securities to variable rate bonds; NMEAF expects to convert soon
- Credit crunch has led investors to seek safe, liquid assets
- Volatility in interest rates have tested derivatives such as interest rate swaps
- NMFA and UNM both use interest rate swaps and variable or auction rate bonds to create a synthetic fixed rate rather than a true fixed rate
- Board of Finance approves most interest rate swaps
- State Treasurer sits on Board of Finance and the boards of NM Mortgage Finance Authority and NM Educational Assistance Foundation but not on board of NMFA

the 5 year LIBOR and receives payments based on SIFMA. This hedges differences between the two indexes.

**Bond Insurance** – Bond insurance can be purchased by a bond issuer to provide a backup for the timely and complete payment of debt service. An issuer will often buy insurance to raise the rating of the bond (it will carry the bond insurance company rating rather than the issuer's rating), which may lower the total interest rates and interest costs for the issuer. At the beginning of 2008, many bond insurers faced financial difficulties and have been downgraded. As a result, the added value of having an insured bond has been reduced for high quality debt issuers.

**Cost of issuance** – the amount of fees required to issue a bond. These costs include the costs for marketing and selling the bonds and legal costs.

**Counterparty** – a bank or financial institution that is the other party in a swap transaction. When NMFA enters into an **interest rate swap**, NMFA is typically agreeing to pay a counterparty a fixed interest rate and receive a variable rate.

**Fixed rate bond** – a fixed rate bond (FRB) is similar to a mortgage on a house: at issuance, all of the components are locked in so both the issuer and the investor knows the principal to be repaid, the interest rate, and the maturity. The rate for an FRB can vary depending on market conditions

## STATUS OF NM AGENCIES/ENTITIES

Most of the debt issued by NM agencies and entities is fixed rate, long term debt and such outstanding debt is not affected by what is going on in the variable rate and auction rate markets. Since the state's credit rating is so strong, debt issues here may be more competitive in the future (as investors continue their flight to quality), but as the chart above shows the future interest rates for longer term maturities (greater than 15-20 years) are uncertain as the demand is limited. When demand goes down, the yield of a bond goes up, meaning it costs more to service the debt.

Both NMFA and UNM have entered into interest rate swap transactions in an effort to both lower the total all-in interest rate and mitigate volatility in debt service cash flow. As long as the index and the variable rate owed the bond holder have a close relationship (and narrow spread), the issuer faces a synthetic fixed rate for debt service which should be lower than a true fixed rate. When the relationship between the variable rate and the index diverge significantly, as happened with the ARS market failure, the issuer faces higher costs to service the debt. NMFA, even considering the last few months' failed auctions, has a synthetic fixed rate of approximately 4.223 percent on the GRIP Series 2004 debt service (as of 4/2/08). This compares to a fixed rate of 4.8 percent that was available at the time of issuance.

**State of New Mexico (Board of Finance).** The Board of Finance currently has approximately \$917 million outstanding in fixed rate debt with 10-year maturities. Most of the capital outlay projects financed from severance tax revenues are done with short term notes, or "sponge" bonds, which are not affected by the current turmoil. BOF does approve certain types of financing such as interest rate swaps for local government entities. Outstanding swap agreements approved by BOF are for the University of New Mexico (UNM) and NM Department of Transportation (via New Mexico Finance Authority (NMFA)), which are all discussed below. BOF will be issuing a senior severance tax bond in June of \$156.4 million which could face higher relative interest rates than recent similar bond issues.

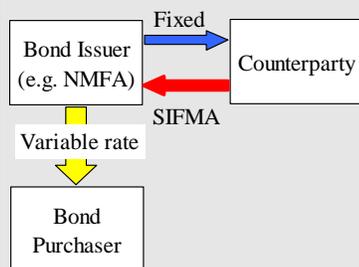
*Interest rate swap approval.* BOF has a policy requirement that the entity requesting permission from the board must address to enter into an interest rate swap. According to a memo (attached) from Olivia Padilla-Jackson, Director of BOF, to the board members, an entity should

- Be able to clearly articulate the purpose of the swap

and the debt rating the bond receives. Bonds with higher ratings from one of the ratings agencies (S&P, Moody's, Fitch) will be able to command lower interest rates. **Senior lien bonds**, or bonds that get repaid first in a hierarchy (like a first mortgage), generally have higher ratings—and lower interest rates—than **subordinate lien bonds**.

**Interest rate swap** – an interest rate swap is when one party promises to pay a fixed rate on a **notional** amount of debt and another party (the **counterparty**) promises to pay a variable rate, usually attached to a common index such as **SIFMA** or **LIBOR**. A bond issuer may want to enter into an interest rate swap to decrease the cash flow volatility. The swap is expected to create a **synthetic fixed rate** that the issuer relies upon for planning debt service.

There are three applicable rates for the issuer that has purchased an interest rate swap: the underlying bond rate, the fixed payment rate and the variable receipt rate. The combination of these three rates create the synthetic rate.



The formula for the issuer's debt service is  
**Variable rate + (Fixed rate – SIFMA)**  
 (assumes SIFMA is the counterparty swap rate)

transactions

- Understand various risks

Director Padilla-Jackson reported to LFC staff that the board requires the officers or key staff of the entity rather than the financial advisors to be able to articulate the purpose of the swap and demonstrate their understanding of the risks. These requirements for approval are critical to preventing unsound financial contracts.

One criticism of BOF is that there needs to be more long term monitoring of financing strategies undertaken by agencies that have to get BOF approval. The case of Birmingham, Alabama, is illustrative of what happens without careful monitoring by financial experts. Birmingham, through a series of actions, ended up with \$5.4 billion of swaps on an underlying debt of \$3.2 billion. As the Birmingham News reported, “Having more notional value than the actual amount of bonds appears unique in the United States,” In this case, which is extreme and not found anywhere in New Mexico, the county was speculating on interest rates in the guise of hedging interest rates and lost the bet. In a Wall Street Journal article, county officials stated that the same advisors that got them into the swaps were now offering help to get them out for a fee.

**New Mexico Finance Authority.** Most of the action has been at NMFA. NMFA manages the debt for the NM DOT transportation projects authorized by Governor Richardson Investment Partnership (GRIP) legislation as well as public project revolving fund (PPRF) bonds which finance local government projects across the state. The PPRF bonds are fixed rate, 30-year bonds while the GRIP bonds are variable rate 20-year bonds. Approximately \$680 million of the GRIP bonds were fixed rate bonds. The rates for the remaining GRIP bonds were set at auction for all \$470 million until April 14, 2008, when NMFA was able to convert \$335 million to variable rate demand notes at the SIFMA rate plus 25 basis points. This lowered the interest rate NMFA pays on these bonds from a range of 5 to 6 percent down to 1.55 percent (in the first week of the new bonds). \$135 million is still subject to the auctions until NMFA is able to convert or refinance those.

**Auction Rate Securites (ARS).** NMFA issued the GRIP bonds using the auction rate structure because historically this structure afforded better rates, required long-term bond insurance rather than a short-term letter of credit, and had never experienced widespread failures. The spread between ARS rates and the variable rate demand bond (VRDB) rates had been 4 to 9 basis points in favor of ARS. This may not seem significant, but over a year on \$470 million the savings is

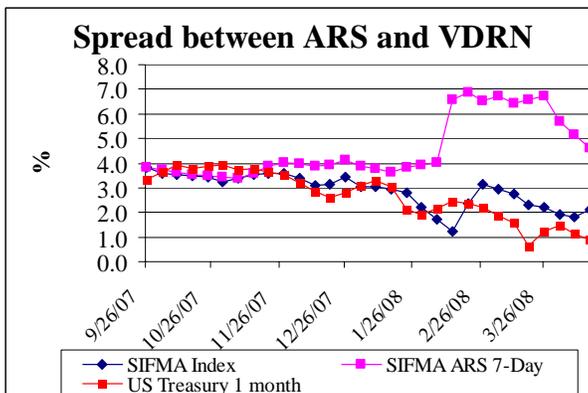
**LIBOR** – London Interbank Offer Rate. This is an index used to benchmark taxable securities. The Wall Street Journal recently reported that this index, one of the backbones of the financial industry, may be sending false signals because some banks may not be reporting high rates on short-term loans fearing a perception of financial weakness. Whether this is true or not, the implications for the banking industry, and the debt markets in particular, are enormous. The British Bankers’ Association, which maintains LIBOR, has opened an inquiry to ensure its credibility.

**Par Value** – the face value of a bond. Most of the bonds sold by NM entities have a par value of \$5,000.

**Premium** – The premium is an additional amount a bond purchaser will pay to buy a bond at a certain yield (the bond interest rates is higher than its yield).

**Rating** – the assessment of credit quality by a rating agency which is used by investors to assess the risk that they will not be repaid on time and in full.

several million dollars which could be used to fund additional road projects. However, in November of 2007, the spread began to widen with ARS interest rates exceeding VRDB rates due to the bond insurer credit rating stress and investor liquidity concerns outlined above. By mid-December the interest rate spread between ARS and VRDBs widened considerably and continued to spread apart until February, when investors ceased bidding on most auctions. NMFA auctions began to fail at this point.



The NMFA bonds were in two series: a 2004 Series of \$200 million and a 2006 Series of \$270 million (including \$50 million taxable bonds). With the failed auctions the older 2004 Series has a formulaic maximum auction rate equal to 175 percent of the SIFMA index (which is successor name of the BMA index; SIFMA is Securities Industry and Financial Markets Association) and so the highest reset over the last several weeks has been 5.469%. The 2006 series, however, had no formulaic maximum rate; rather, the maximum rate is the statutory NM maximum rate of 12 percent (6-14-3 NMSA 1978). The 2004 series, because of the relatively low maximum rate, has consistently failed over the past two months. The 2006 series only got to 12 percent twice: once for an \$80 million portion and once for a \$25 million portion (which was not a tax-exempt series). The 2006 Series did not fail as much because another class of investors who were attracted to high quality bonds with the potential for high interest rates began bidding on the auctions with high maximum rates. As the table below shows, prior to November, all but one portion of the ARS fared better than the SIFMA index (or LIBOR in the case of the 2006 D1 and 2006 D2, which are taxable). After November, that relationship reversed and the auctions averaged as high as 200 basis points (2.00%) higher than the SIFMA index.

There are three ratings agencies: Moody's, Fitch, and Standard and Poor's. Most of the debt issues in New Mexico have very high credit ratings. Using bond insurance will cause the bond to carry the insurance company's rating rather than the issuer's rating.

**Refunding** – refunding refers to the refinancing of older, higher rate bonds with a new debt issue. Usually done to take advantage of lower rates, but issuers also refund to correct disadvantageous situations like auction failures. A rule of thumb is that refunding should only happen if the refunding results in at least 3 percent present value savings.

**Senior lien bond** – a senior bond is the first to get paid by a bond issuer and so commands a better price for the issuer and has lower risk for the purchaser. This is analogous to a first mortgage on a home.

**SIFMA** – The Securities Industry and Financial Markets Association. Most often refers to an index of tax-exempt securities and is used to benchmark municipal bonds. Formerly known as the Bond Market Association (BMA) index.

**Summary of NMFA interest rate swaps**

| Series             | Amount     | Reset Rate           | Auction Rate/SIFMA or LIBOR spread |              |
|--------------------|------------|----------------------|------------------------------------|--------------|
|                    |            |                      | Spread Prior to November 2007      | Spread After |
| 2004 C 1           | 80,000,000 | 175 % of SIFMA (BMA) | (0.065)                            | 1.495        |
| 2004 C 2           | 80,000,000 | 175 % of SIFMA (BMA) | (0.093)                            | 1.065        |
| 2004 C 3           | 40,000,000 | 175 % of SIFMA (BMA) | (0.067)                            | 1.609        |
| 2006 C 1           | 70,000,000 | 12 % (statute)       | (0.039)                            | 1.683        |
| 2006 C 2           | 80,000,000 | 12 % (statute)       | (0.029)                            | 2.033        |
| 2006 C 3           | 70,000,000 | 12 % (statute)       | 0.026                              | 2.482        |
| 2006 D 1 (Taxable) | 25,200,000 | 12 % (statute)       | (0.174)                            | 1.437        |
| 2006 D 2 (Taxable) | 25,200,000 | 12 % (statute)       | (0.215)                            | 1.541        |

Source: NMFA

*Interest rate swaps.* The SIFMA index is an important tax-exempt benchmark not only to have a relative performance gauge, but because NMFA also is using interest rate swaps to synthetically fix the debt service costs. In the case of the 2004 Series, NMFA pays a counterparty a fixed rate of 3.934 percent and receives the SIFMA index. As is the case whenever the actual bond rate exceeds the SIFMA index, as is currently the case, NMFA's net payments include the fixed swap rate plus the difference between SIFMA and the actual bond rate.

*PPRF Bonds and Insurance.* Due to the debacle in the bond insurance industry, NMFA went out to the market on the 2008A PPRF bonds without insurance. Insurance in the past was worth the premium because of the higher rating (and commensurately lower interest rates) of an insured bond, but NMFA has a strong enough rating on its own that insurance, at this point, is not always cost-effective. The 2008A issue was sold at 4.71 percent all-in true interest cost.

*Status of ARS.* As mentioned, NMFA has been successful in refunding \$335 million of the \$470 million of auction rate securities. Because of the strong credit of NMFA, two banks—State Street and UBS—have provided letters of credit that guarantee payment on the bonds. The rate on the remaining \$135 million will continue to be set at auction but most of it has a low reset rate of 175 percent of SIFMA, currently around 3 to 4 percent. The bulk of the refunding was the debt that would reset at 12 percent.

**Subordinate lien bond** – a subordinate bond is a lower-tier bond that is paid after any senior bonds are paid. The lower status means that there is more risk for purchasers and so the yield is higher than for senior bonds.

**Synthetic fixed rate** – the ultimate interest rate an issuer pays as a result of an **interest rate swap** and a variable rate bond (assuming that the variable swap payment equals or offsets the variable bond payment). Both NMFA and UNM use interest rate swaps with the expectation that the “all-in” rate for debt service will be less than a conventional fixed rate bond.

**Tranche** – a subsection of a debt instrument. From the French word for “slice,” a tranche often refers to a subsection of a collateralized mortgage obligation (CMO) that is broken out by risk level. Tranches can also refer to subsections of a bond that have different risk parameters such as different maturities.

**Summary of 2008 Refundings**

| New subseries | Amount (\$)      | LOC provider | Refunded Subseries |
|---------------|------------------|--------------|--------------------|
| A-1           | 35.20            | State Street | 2004-C1            |
| A-2           | 80.00            | UBS          | 2004-C2            |
| B-1           | 100.00           | State Street | 2006-C1/2006-C3    |
| B-2           | 120.00           | UBS          | 2006-C2/2006-C3    |
| <b>Total</b>  | <b>\$ 335.20</b> |              |                    |

**Remaining Auction Rate Debt**

|              |                  |
|--------------|------------------|
| 2004-C1      | \$ 44.80         |
| 2004-C3      | 40.00            |
| 2006-D1      | 25.20 *          |
| 2006-D2      | 25.20 *          |
| <b>Total</b> | <b>\$ 135.20</b> |

\* 2006-D1 and 2006-D2 are taxable bonds.  
source: NMFA/First Southwest

**University of New Mexico.** The University of New Mexico currently has \$488 million of outstanding debt. This amount excludes the debt for the University of New Mexico Hospital in the amount of \$192 million which is considered non-recourse to the university. The university’s bond ratings are AA from S&P and Aa3 from Moody’s with a stable outlook. UNM has a debt investment advisory committee which reviews overall debt and investment on a quarterly basis.

Of the \$488 million of outstanding debt, \$380 million, or 78 percent, of which is fixed rate bonds. Variable rate debt and synthetic fixed rate swaps account for 5 percent and 17 percent of the university’s outstanding debt, respectively.

UNM has several synthetic fixed rate transactions involving swaps:

- 1) The 2001 bond issue has two swaps in notional amounts of \$11.5 million each, for a total of \$23 million. The first is with RBC Dain Rauscher at 4.185 percent, while the second is with JP Morgan at 4.160 percent.
- 2) The 2002B issue has a swap in notional amount of \$25.5 million with JP Morgan at 3.830 percent.
- 3) The 2002C refunding has a swap in notional amount just under \$37 million with JP Morgan at 3.940 percent.

UNM receives BMA on all of these swaps. UNM is the only party that may terminate the swap without cause. JP Morgan can terminate, but it requires “cause”.

**Variable rate demand note** – a variable rate demand note (VRDN) is a bond whose interest rate is determined by a negotiated remarketing between an investment bank (working to set the interest rates for the issuer) and investors. In normal markets, the interest rates approximate a common index such as **SIFMA** (for tax-exempt) or **LIBOR** (for taxable). Compared to a **fixed rate bond** (FRB), the stream of payments for a VRDN is not known but the expected interest rates over time and the **costs of issuance** for VRDNs are typically lower than for FRBs which are why they can be more attractive than FRBs. In the interest rate environment of the last few years, VRDNs have been attractive and useful at keeping debt service low compared to FRB. However, they are short term rates and can adjust frequently which increases the uncertainty for long term financing.

There are several basis overlay agreements, which are normally called basis swaps, tied to most of the original swaps. Specifically, there is: 1) an overlay agreement tied to the \$23 million swap associated with the 2001 bond issue at 63.55 percent of 5-year LIBOR plus .31 percent and 2) another overlay agreement for just under \$37 million tied to the 2002C refunding swap at 63.93 percent of 5-year LIBOR plus .38 percent. UNM pays BMA on both.

The purpose of the overlays is to gain an advantage of higher receipt payment rates from the traditional upward sloping yield curve environment. The basis overlay agreement swaps are currently hedging the university's position on the underlying swaps. For example, according to UNM staff, the projected June 1, 2008 interest cost from the underlying swaps is approximately \$477,000. Due to the overlay agreement, J. P. Morgan is expected to pay the university approximately \$337,000. The net interest payment for the swap elements of UNM's bonds is thus projected for June 1, 2008 at \$139,000.

The maturity of the overlay agreement swaps is in effect through the life of the underlying swap unless either party recommends termination. The overlay's terms tie exactly to the underlying swap.

UNM senior management indicates the university's focus will be to continue to maintain its current ratings, while using traditional fixed rate bonds given favorable interest rates. The university anticipates a potential bond issue for capital improvements in the next four to five years to address student housing and associated student services.

**New Mexico Mortgage Finance Authority.** The MFA does not have a formal written debt issuance policy. Since inception, its practice, as approved by the MFA's Board upon each debt issuance, has been to avoid incurring interest rate risk. Generally MFA issues structured fixed-rate debt, for the financing of fixed-rate loans.

In the situations where the Board has approved the issuance of variable rate debt, the transactions have been structured so that MFA does not incur any interest rate risk. Therefore MFA does not purchase any hedges, such as interest rate swaps.

**NM Student Loans.** The Educational Assistance Act was enacted to stimulate "the availability of financial assistance for post-secondary education..." (Chapter 21, Article 21A NMSA 1978). The Act authorizes a nonprofit guarantee corporation which insures educational loans, and the New Mexico Student Loan Guarantee

**Yield** – the rate of return on a bond, adjusted for the price paid by the purchaser.

**Yield Curve** – The yield curve is the graphic depiction of yields of bonds with different maturities from short term (1 month) to long term (30 years). Typically, an upward sloping yield curve reflects an efficient market as the risks associated with long term bonds require a higher yield. An inverted yield curve where the short term yields are higher than long term indicates pessimism about the future and is often cited as a precursor to a recession.

Yield curve on 4/21/08



Source: MarketWatch, Inc

Corporation (NMSLGC) provides a statewide educational loan program (21-21A-4 NMSA 1978). The primary function of the NMSLGC is to guarantee Federal Family Education Loan Program loans for New Mexico residents and students who attend in-state postsecondary institutions. The Act also authorizes a nonprofit foundation, the New Mexico Educational Assistance Foundation (NMEAF) “to provide financial assistance to qualified persons, including a program of making, financing, purchasing, holding and selling educational loans, and by servicing educational loan, scholarship, grant, work study and other education assistance program” (21-21A-5 NMSA 1978). Powers of the foundation are found in 21-21A-7 NMSA 1978. The foundation is authorized to issue bonds and enter into trust agreements. Assets or revenues of the foundation may be pledged for these bond issuances. Section 21-21A-17 authorizes investment of funds. The Act provides for an annual report and audit of the foundation and the corporation.

The NMEAF emphasizes that it is a self-supporting entity, with 165 full time equivalent staff. Further, it has a defined contribution retirement plan, self-funded employee health and dental insurance plans and a management incentive (bonus) plan. According to its 2007 Annual Report, the Foundation has assets of more than \$1 billion. NMEAF has \$900 million of student loans and serves 70,000 borrowers. Its bonds are special obligations of the foundation and are not considered a debt, liability or obligation of the state. Further, these bonds do not directly impact the state’s credit rating. The NMEAF retains co-bond counsel of Sutin, Thayer and Browne along with Orrick, Herrington and Sutcliffe. Unlike the other state entities, the NMEAF does not retain a financial advisor.

NMEAF has issued approximately \$620 million of auction rate bonds, or 69 percent of its outstanding debt. Virtually all of these auctions for the securities held by the NMEAF are currently failing. In this case, when the 35-day reset auction fails to attract enough bidders, it converts to a 7-day auction reset period with a maximum auction rate equal to 200% of the S&P high grade index. As of April 15, 2008, that rate was 3.84 percent. This rate has the tendency to change day-by-day, but the recent range was 3.5 to 4.1 percent. In February 2008, this rate was as high as 5.92 percent. NMEAF emphasizes that a failed auction is not a payment default on its bonds, but signals there are not enough buyers at a given rate. If NMEAF were to default on the bonds, the maximum interest rate would escalate to 12 percent.

In February 2008, NMEAF began a process to convert or refund \$436 million of auction rate bonds to variable rate demand notes. As of this writing, another special board meeting is scheduled to consider a letter

of credit to back these notes. The deal is now expected to close during the second week of May. The new instruments will be privately sold. Mr. Farber, President of the NMEAF and the NMSLGC, will be presenting more detail to the committee at the hearing.

**State Treasurer's Office (STO).** STO has a unique role in the events of the last few months. The state treasurer, James Lewis, sits on the Board of Finance, board of NMMFA and the board of NMEAF. The treasurer is not on the board of NMFA, however, In this role and the role of the State's financial officer, STO has been monitoring these issues very closely. One of the early discussed options to prevent the auctions from failing for both NMFA and NM Student Loans was for STO (or the State Investment Council) to become a bidder in the auctions. NMFA, in particular, wanted STO or SIC to bid on the auctions once the refunding was in place, ensuring that neither agency would be exposed to long term liquidity risk. So far neither agency has plans to bid in either the NMFA or the NM Student Loans auctions.

#### QUESTIONS

1. Is there any benefit to bond insurance at this point?
2. How much has the state saved in debt service by using auctions to determine rates or swaps to hedge interest?
3. What, if anything, is the federal government doing to help out public finance entities?
4. Should the legislature look at tightening statutes to limit the options of state entities that have the power to issue bonds?
5. How is the increased debt service going to affect capital outlay projects?
6. For NMEAF: At this point, what has NMEAF gained? What has NMEAF lost since the auction rate securities started failing?
7. For UNM: What were the advantages of developing swaps? Why is the university holding swaps on top of swaps?
8. For STO: How can the treasurer help either NMFA or NMEAF while they pursue refunding options?
9. For STO or NMFA: Should the treasurer be on the board of NMFA like the other boards?
10. What is the Executive branch or State Treasurer's Office doing to monitor state debt issues on an on-going basis?

NF/AW/SEC

