

# Variable Rate Demand Obligation Primer

## Overview

Variable Rate Demand Obligations (VRDOs) are long-term, tax-exempt bonds whose interest rates generally reset on a daily, weekly or monthly basis.

VRDOs are typically issued with long-dated maturities of 20 to 30 years, and are purchased by investors at par in \$100,000 increments. When investors want to redeem their VRDOs, they may do so through a put feature that allows them to put the bond back to an investment dealer at par plus any accrued interest. The redemption schedule generally coincides with the interest rate reset schedule. While each bond is issued with its own unique coupon rate, the interest rate resets tend to track proportionately with changes in the broader VRDO market, which are reflected in the SIFMA Municipal Swap Index.

The credibility of the put feature rests on the fact that virtually all VRDOs are structured to include a contractual source of liquidity support. This support generally comes in the form of either a letter of credit (LOC) or a standby bond purchase agreement (SBPA) usually provided by a large multinational financial institution. Given the important role of the liquidity providers, the construction of a VRDO portfolio should factor in diversification among LOC and SBPA providers.

If an investment dealer finds itself unable to remarket a VRDO, it can liquidate the bond through the bond's designated liquidity provider. This credit and liquidity enhancement allows for a VRDO to receive Moody's and S&P's highest credit ratings within the short-term, tax-exempt category.\*

## Credit Enhancement

### Letter of credit

A VRDO may be structured with a LOC, which is an unconditional liquidity-demand feature that is generally provided by a highly rated bank and is typically irrevocable during its term. As the liquidity provider of last resort, the bank's credit rating is often assigned to the bond in place of the rating of the issuer.

The LOC can be structured in at least two ways. A **direct** LOC designates the bank as the first source of payment of principal and interest. The bond issuer would be liable to pay only if the bank fails to meet its obligation to provide liquidity in accordance with the terms of the issue. With a **standby** LOC, the issuer is the first source of liquidity, with the bank acting as a back-up should the issuer fail to make its principal and interest payments.

- **Liquidity Risk:** Lower than insured VRDOs backed by SBPAs. There is limited liquidity risk in these issues since most LOCs are irrevocable. While the term of the LOC is relatively short, which exposes investors to renewal risk, the expiration of a LOC would trigger a mandatory put. While most of the LOCs appear to be irrevocable, the terms of each deal can vary greatly and there may be circumstances under which the LOC could be revoked prior to its maturity.
- **Credit Risk:** Relatively Low. These VRDOs take the long-term credit rating of the bank that issues the LOC. In most cases, these are large, highly rated banks. However, it is important to continuously monitor their rating for downgrades. The credit risk is somewhat mitigated since the issues contain a short-term put option.

### Standby bond purchase agreement

A VRDO may also be issued with a SBPA as the contractual source of liquidity. Under this structure, the bond is insured by an investment grade insurance provider. If the bond cannot be remarketed, the SBPA provider is obligated to buy the bonds as long as the insurer maintains its investment grade rating. The result is that the issuer takes on the credit rating of the insurer, who guarantees to pay principal and interest if the issuer defaults.

- **Liquidity Risk:** Higher than VRDOs backed by LOCs. SPBAs can be terminated by the issuing bank if the credit ratings of the monoline insurer are downgraded below a certain level. The terms of each deal can vary greatly, and it is important to know the events of termination for SBPAs, which are specified in the official statement. The standard language generally states that the liquidity provider (the bank issuing the SBPA) is no longer obligated to provide liquidity if any of the following occurs:
  - i) The insurer declares insolvency or inability to pay its debt.
  - ii) The insurer is downgraded below investment grade or the rating is suspended by all three credit rating agencies.
  - iii) The insurer defaults on principal or interest payments covered under the insurance policy.
  - iv) The bond is declared taxable by the IRS.
  - v) The insurance policy is ruled invalid by a court or government authority.
- **Credit Risk:** Generally higher than those backed by LOCs. The insured VRDOs take their long-term rating from the bond insurer. Given the rating downgrades of several monoline insurers in 2008 and the uncertainty surrounding the industry, these deals contain more credit risk than those supported by LOCs from highly rated banks.

### The VRDO Market

The high quality and liquidity of VRDOs may make them attractive to various types of investors, including corporations, individuals, money market funds and other institutions. Money market funds have historically been the largest holders of VRDOs as they must maintain specific quality and maturity standards. A VRDO's ability to be sold back at par is helpful to fund managers in meeting those standards.

### Structural benefits

The VRDO structure offers unique benefits to both issuers and investors. Their structure enables borrowing entities (such as state and local governments) to issue long-dated securities while still taking advantage of rates at the shorter end of the yield curve. The ability to redeem at par on a frequent and regular schedule combined with the interest rate reset may offer investors the ability to generate tax-free income in a very low-duration investment.

### Taxes

Perhaps the most significant benefit of municipal securities, such as VRDOs, is that their interest income is exempt from federal taxes and may in some instances be exempt from state and local taxes for residents of the issuing state. As an investor's marginal tax rate increases, so does the benefit of tax-free income. For example, an investor who jumps from the 15% tax bracket to the 35% tax bracket would have to pick up an additional 109 basis points in an equivalent taxable yield in order to get the same yield as a municipal bond paying 3%.

State and local taxes may apply.

### Equivalent taxable yields for selected marginal tax rates (%)

Municipal Coupon (%)	Investor's Federal Tax Bracket		
	15%	28%	35%
2.0	2.35	2.78	3.08
2.5	2.94	3.47	3.85
3.0	3.53	4.17	4.62
3.5	4.12	4.86	5.38
4.0	4.71	5.56	6.15

Source: Invesco PowerShares

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If you have questions about VRDOs or would like to learn how Invesco PowerShares can provide exposure to VRDOs, please call **800 983 0903** or email [info@invescopowershares.com](mailto:info@invescopowershares.com).

A put feature allows an investor to sell a security at a specified time and price.

A standby bond purchases agreement is a contractual source of liquidity from a financial institution enabling them to sell their bond at par plus accrued interest.

A letter of credit is a contractual source of liquidity from a financial institution enabling investors to sell their bond at par plus accrued interest.

\* The S&P and Moody's credit ratings are designed to rank the credit-worthiness of borrowers using a standardized ratings scale. Despite a high rating, the VRDO is still subject to risks. VRDOs are considered short-term instruments because of their put feature enabling them to be redeemed at par at any time.

Note: Not all products are available through all firms.

The information presented does not constitute tax advice. Please consult your tax advisor for specific information about your tax situation. Some VRDOs are subject to the Alternative Minimum Tax.

VRDOs are high-quality, floating-rate bonds that provide investors with tax-exempt income in a short-term time frame. VRDOs are always purchased at par. When they are put back to an investment dealer, the investor receives par plus accrued interest. Yields are generally reset on a weekly basis.

The Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index, produced by Municipal Market Data (MMD), is a seven-day high-grade market index comprised of tax-exempt VRDOs from MMD's extensive database.

There are risks involved with investing in ETFs, including possible loss of money. Shares are not actively managed and are subject to risks similar to those of stocks, including those regarding short selling and margin maintenance requirements. Ordinary brokerage commissions apply.

**Variable Rate Debt Obligations Risk: There may not be an active secondary market with respect to particular variable rate instruments, which could make it difficult to dispose of a variable rate instrument if the issuer and/or the Remarketing Agent defaulted on its payment obligation or during periods that an investor is not entitled to exercise its demand rights, and an investor could, for these or other reasons, suffer a loss with respect to such instruments. Municipal securities are subject to the risk that litigation, legislation or other political events; local business or economic conditions; or the bankruptcy of the issuer could have a significant effect on an issuer's ability to make payments of principal and/or interest. Municipal securities can be significantly affected by political changes as well as uncertainties in the municipal market related to taxation, legislative changes or the rights of municipal security holders. Because many securities are issued to finance similar projects, especially those relating to education, health care, transportation and utilities, conditions in those sectors can affect the overall municipal market. In addition, changes in the financial condition of an individual municipal insurer can affect the overall municipal market. Municipal insurance does not protect against losses.**

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Shares are not individually redeemable and owners of the shares may acquire those shares from the Funds and tender those shares for redemption to the Funds in Creation Unit aggregations only, typically consisting of 50,000 shares.