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INSIDE DERIVATIVES

Oakland Deal: Priced as Swap, Funded as Taxable Muni

By Peter Heap

The so-called swaption for Oakland effectively separates the funding and pricing components of issuing the debt, according to **Don Rice**, president and chief executive officer of **GBR Financial Products Co.**, who arranged the deal.

Money was raised in the efficient, low-cost short-term market, while the long-term interest rate depended on the 10-year cost of borrowing in the highly liquid swap market – avoiding the inefficiencies and high costs of the taxable municipal market.

The swaption, on \$140 million of bonds, was part of a \$188.5 million deal on Sept. 12 to finance improvements to the Oakland Coliseum.

Approximately \$10 million of fixed-rate tax-exempt securities were sold to retire existing debt.

The remainder was sold as variable-rate taxable debt, structured to look like commercial paper. Although the bonds have a 30-year maturity – with some amortization towards the end – they have a regular reset according to the **Federal Reserve** commercial paper index.

The swap runs for 100 years and converts Oakland's floating exposure to fixed rate.

Just under \$40 million of variable-rate exposure will be retained and then retired in the near future, said GBR vice president and senior trader **Michael Murray**.

Grigsby Brandford & Co. underwrote the deal, with **Goldman, Sachs & Co.** as co-manager. The issuer

was **Oakland-Alameda Joint Powers Authority**.

GBR, which has links to Grigsby Brandford, and Goldman also acted as counterparties on the swap. Both were triple-A rated, GBR because it has credit support from a triple-A rated insurance company, Goldman through a special-purpose derivatives vehicle.

The option component was linked to credit issues.

Variable-rate bonds would in any case commonly have enhancement, Rice said, but GBR specifically wanted some kind of security for the swap.

As a result the issue and the swap were backed by letters of credit provided by **Canadian Imperial Bank of Commerce**.

However, a letter of credit only provides a specific amount of enhancement while a swap could, under appropriate market conditions, have large swings in value.

As a result, the transaction included a clause to limit the liability of the issuer – and so the liability of the letter of credit provider – to GBR should there be a default or other credit event on the part of Oakland-Alameda. The arrangement is effectively an option.

For example, if a municipality was paying a derivative deal a fixed rate of 8% on a swap, this kind of option could be set up to ensure the dealer receives at least 7% in the event of a default – even if the market interest rate goes as low as 3%.

The option does not come into play in any circumstances other than a credit event.

Rice declined to reveal the fixed rate on the swap or the amount of protection built into the letter of credit other than to say it was approximately 10% of the notional value of the swap.

"What the option does is to limit our loss to be no greater than the size of the letter of credit," Rice explained. "The loss limitation is in effect an interest rate option that limits the effect of downward movements on the swap."

In fact, from the municipality's point of view the option simply appears as extra wording in the transaction contract – although the addition does cost money.

"There's a cost component for us; there's a cost component for the municipality," Rice commented.

GBR, on the other hand, had to enter into another option as part of its hedging of the whole deal – the standard practice by which derivative dealers pass on the risks to other parts of the market, leaving themselves with a smaller but relatively risk-free spread.

The variable rate on the swap is designed to closely match the commercial paper rate on the underlying bonds, Rice added.

Although the debt has a 30-year maturity, the swap runs for 10 years, which Rice said was meant to give Oakland the ability to redeem the bonds after that period.

Alternatively, they could enter into another swap at that point – or before the 10 years have expired – or sell fixed-rate bonds.

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