CALIFORNIA EDUCATIONAL FACILITIES AUTHORITY
February 28, 2002

Item #11 – Tax-Exempt Commercial Paper Financing
(Information Item)

In anticipation of expected requests to consider the issuance of Tax-exempt Commercial Paper (TECP) rather than the traditional fixed or variable rate bonds, staff wants to briefly describe what TECP is, how it works, what the benefits would be for certain CEFA borrowers and finally, the impact on CEFA.

What is TECP?

Tax-exempt Commercial Paper is the issuance of a series of short-term notes, with maturities ranging from 1 to 270 days. The interest rate on each maturity is fixed at the time of issuance, based on market conditions. The rate changes when the issue matures, if it is rolled over (remarketed) to a new maturity. A TECP program usually consists of a series of issues, each at a fixed rate, which, when taken as a whole, produces a variable borrowing cost for the overall debt. TECP is issued in minimum denominations of $100,000. The combination of this minimum denomination and maximum maturity of 270 days, allows the security to be exempt from the continuing disclosure requirements of Rule 15c2-12.

TECP normally attracts institutional investors and is limited to the highest credit quality. Short term ratings of A-1+ and A-1 (Standard & Poor's), P-1 (Moody's) and F-1+ and F-1 (Fitch) are required to attract investor interest. Due to the unlikely but possible risk that market conditions would not exist at the time that the paper is due to be remarketed on a particular maturity date, an issuer or bank-provided liquidity facility is required to ensure funds are available to provide payment for notes maturing. The ratings applied to the TECP generally reflect the ratings of the entity providing liquidity support.

How does it work?

TECP requires professionals similar to that of a variable rate demand bond issue: An investment banker (TECP Dealer) to sell the securities; a bank serving in the capacity of an Issuing and Paying Agent (IPA) to coordinate issuances, receive/release funds and pay principal and interest to investors (sometimes also assuming the role of Trustee if the TECP is issued pursuant to a bond indenture); the Depository Trust Company (DTC) for registration of notes; investors, borrowers and an issuer (CEFA).

Based upon the request of the borrower and the authorization by CEFA, the TECP Dealer's sales force markets a new issuance of TECP and coordinates such activities with the IPA. Orders are matched through DTC and the IPA. The securities are delivered by

the IPA to the TECP Dealer via DTC and subsequently delivered to investor accounts. Funds are deposited with the IPA and the securities are released to the investor. Upon each maturity date, notes are generally rolled over automatically (unless the borrower wishes to prepay the notes) without requiring specific authorization or instructions by the borrower or CEFA. It would be contemplated that CEFA would authorize the entire program prior to inception and would not need to be involved on a trade-by-trade basis. If the overall size of the program were to be increased, such a change would have to be brought back to CEFA for approval.

Notes are issued at a fixed rate for a specific maturity, based upon the requirements of the borrower and the market. Interest is paid on each respective maturity date. Issues can be completed on any business day, with varying terms, so that maturities will be staggered throughout a wide range. As mentioned, as notes mature, they can be rolled-over in total (principal only) or in a lesser amount, should the borrower choose to pay down some of the debt. The roll-over note will have a new fixed interest rate and a new maturity date. The total of new and rolled-over notes cannot exceed at any time the maximum amount approved by resolution of the borrower and CEFA.

Tax-exempt money market funds are the primary purchasers of TECP, and use TECP as a means to manage their overall portfolio duration. On each day the TECP is to be placed or remarketed, the TECP Dealer will present a broad maturity scale with corresponding interest rates to potential investors. Interest rates established for each maturity take into account economic and technical trends in the marketplace, and additionally reflect information received from recent trading activity. By providing a broad range of choices, it allows money market funds to select the best option for their specific portfolio needs. The borrower and CEFA can prescribe maturity restrictions, if desired, in order to accomplish any specific goals such as prepayments. Maturities generally average between 30 and 60 days and trade closely to comparable seven-day variable rate programs.

What are the benefits?

With a traditional bond issue, whether fixed or variable rate, all bond proceeds are deposited with the Trustee at the time of closing. Borrowers typically issue bonds in an amount sufficient to fund one or more construction projects in their entirety. Laws governing tax-exempt bonds generally allow a period of up to three years to spend the proceeds on construction projects, however, investment earnings on the funds (arbitrage) is restricted to the bond yield. Thus, borrowers must issue bonds up front in amounts sufficient to complete extended project timelines, but cannot offset a portion of the costs of the outstanding bonds by profitable investment of the funds not yet spent. Even if capitalized interest is funded from bond proceeds to pay bond interest costs during construction, the original issue size must be increased to cover both construction and capitalized interest costs, resulting in a higher overall cost for the bonds.

For certain colleges and universities, TECP may be a more efficient mechanism for financing numerous or extended projects. First, note issuance can be timed to coincide

with the exact need for funding. Since projects typically are segregated into phases, each phase or components within each phase can be funded only when needed; associated finance costs are therefore phased in as well. Further, contribution and endowment funds designated for projects can be utilized as received in lieu of additional note issuance for better overall management of debt.

Additionally, IRS yield limitations on investment of short-term bond or note proceeds is less restrictive, allowing at least some earnings on proceeds to be utilized for project costs.

While the concept of using TECP for single construction projects is by itself significant, it is expanded exponentially for those facilities that manage multiple projects on a continuous basis. TECP can be issued as needed for each project, thus allowing borrowers to better manage financing costs of all congruent projects.

Lastly, but perhaps most important, TECP provides the opportunity to achieve the lowest possible financing costs available. The TECP interest compares favorably to variable rate bonds set in daily or weekly modes, while combining the surety of a fixed rate over a set time period with the ability to issue only the amount you currently need versus what you will need over the next three years.

TECP is not for everyone. As mentioned, the market demands the highest rating levels for short-term financing. Liquidity must be provided or guaranteed, as in variable rate issuances. Ratings are either based on underlying ratings of the college or university or on bank credit enhancement facilities, which can be expensive to obtain. Further, there is a time commitment for the continual monitoring of new placements, roll-overs of matured paper and principal and interest payments. Since interest payments are staggered and may be frequent, the borrower must work closely with the IPA to make sure adequate funds are available.

What is the Impact on CEFA?

CEFA staff will need to evaluate the workload on any proposed TECP program. However, in discussions held to date with parties on existing programs, including the Public Finance Division of the State Treasurer's Office for the State's own TECP program, CEFA staff involvement should be minimal. CEFA would approve a maximum amount to be issued over a period of time by resolution, just as is done currently with normal fixed and variable rate bond issue applications. As each note is issued, staff would participate on the sale as normal, the difference being only the number of issues per resolution. As notes mature, the roll-over would be similar to the reset of variable rate bonds, handled by the TECP Dealer. Rates are reported electronically to CEFA following the event. Borrowers would be required to report any principal reductions that coincide with roll-overs so that debt outstanding can be monitored by CEFA. A maximum maturity for the total issued amount would be included in the approving resolution by CEFA.

Staff has provided this overview on TECP to the Authority as an introduction to another financing mechanism that may be beneficial to the client colleges and universities of CEFA. We know that this program has been provided to colleges in other States and anticipate that some California facilities will want to have it available for them as well. Staff believes that CEFA should try to provide programs that will allow more efficient use of tax-exempt debt for our eligible clients. Staff, in conjunction with legal counsel, will continue to investigate all aspects of a TECP program, including any different or additional issuance documents, with the anticipation of coming back to the Authority with a specific request at a future date.